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RICHARD D. LAMM
Governor

November 16, 1977

It is hard to overstate the impact of Bob Yegge on The University of Denver, The City and County of Denver, and The State of Colorado.

Bob Yegge has worked long and hard, unselfishly and unreservedly, to make his community a better - fairer - more just place. His skills in leadership are superb.

All of Colorado owes him a great debt of gratitude.

Sincerely,

Richard D. Lamm
Governor

ROBERT YEGGE—AN UNUSUAL PERSONAGE

I do not propose here to dwell upon all the credits of Bob Yegge which would appear in a curriculum vitae. The reader will probably be fully informed on these matters anyway in the other writings which will appear in these pages.

What has impressed me most about the Dean is the extraordinary rapport he has with the young people who have touched his life in and out of the university setting. Each time I have been in places where Bob and his students or other young people are, I can actually feel the good vibrations that pass between them. It is inspirational to hear the lively exchanges which are typical of his sessions with his disciples.

Always predominant in these exchanges is a mutual respect for each other's ideas and concerns and because of his affinity for the aspirations, the concerns, and the problems of those who will shape the future course of this society of ours, he has become a dynamic protagonist of the programs which will meet the challenges raised by the generation of the leaders to come.

One last thought comes to me. I envy his ability to become younger, more kinetic, more creative, more vital as he grows chronologically older. That is a rare quality and I know it will continue as he now makes his contribution to a better world in a different setting.

Edward E. Pringle
Chief Justice, Colorado Supreme Court

A Tribute to Robert Yegge

Socrates once said, "Let him that would move the world, first move himself." Robert Yegge is indeed a self-mover and by the maximum utilization of his energy and talents has indeed contributed to a better world for all of us.

We had our first encounter when I was working my way through the University of Denver College of Law, in broadcasting, and Bob was a student leader in high school and producing and directing a radio program for high school students. His writing ability, his flair for the dramatic, and his fertile imagination convinced many of us that he had a bright future in the world of entertainment and the arts. But even then, Bob had his heart in the field of the law. Son of one of Denver's most prominent trial attorneys, Ronald Yegge, Bob displayed a universal interest in almost all disciplines, but he knew in his heart he could not escape his involvement with the legal profession.

Having kept in touch with Bob throughout his undergraduate and law school days, it came as no surprise when he joined the faculty of the University of Denver College of Law as an Adjunct Professor. Shortly thereafter, the University was faced with the task of selecting a dean for the Law School. Those of us who were serving on the selection committee asked the faculty for recommendations of one of their members to serve as Acting Dean while the search continued for the permanent occupier of that position. I was not surprised when recommendations came in from those whom I considered to be the wisest and most venerable of the faculty members suggesting Bob Yegge. After a few months service as interim Dean, several of the faculty contacted me to suggest that we search no further; that Bob Yegge would be the perfect person for the permanent position.

After great agonizing and soul searching, Bob agreed to accept the position and his spectacular performance in the twelve years that he served has been nationally recognized by legal educators and the legal profession.

He has served at a crucial time in the history of legal education. With literally thousands of applicants for relatively few positions in the law schools of our nation, admission to the University of Denver College of Law has become one of the most prized objectives of students throughout the country. Bob Yegge has developed an outstanding faculty, has created more innovative programs and clinical training than any other school in the United States, and has developed a sense of pride in both student body and alumni unequaled in the long history of the University of Denver College of Law.

We who have been privileged to observe his stewardship and have had the opportunity to work with him are grateful beyond description.

Richard M. Schmidt, Jr.
Partner, Cohn & Marks, Washington, D.C.
Member, Board of Trustees, University of Denver

A Time to Remember — Robert B. Yegge's 12 Years (1965-1977) at the University of Denver College of Law

In the spring of 1965, a few days after my acceptance of a teaching position at the University of Denver College of Law, two of my classmates at Yale Law School left a copy of *Dicta* on my desk accompanied by a note which read: "We knew you would select a school of excellent repute. This is the law journal of your new school." I browsed through the publication which was a joint product of the Colorado Bar Association and the College of Law and was disappointed to find that the students did not even have their own publication. Distressed over not having made a thorough investigation of the school before accepting the position, I must admit to having second thoughts about coming to Denver. However, having already accepted the offer, I decided to join the faculty, consoling myself and assuring my friends that I did not have to stay at Denver for more than a year. Now, thirteen years later, I am still here and have no desire to move. The College of Law has three first-rate publications, the *Denver Law Journal*, the *Denver Journal of International Law and Policy*, and the *Transportation Law Journal*, and has started another—*The Clinical Education Perspective* (with the AALS). In addition, two professional journals (*Administrative Law Journal* and the *Law and Society Review*) are now published here. And the person primarily responsible for this transformation is the one to whom this issue of the *Journal* is dedicated—Robert B. Yegge, a distinguished colleague and a close friend who assumed the position of Dean of the College of Law the year I arrived here.

Bob Yegge assumed the leadership of the College of Law in turbulent times. It takes little reflection to recall the divisive pains of a society groping for its identity in the late sixties. These societal challenges reinforced the new dean's basic thesis about legal education: lawyers must possess the understanding and the skills necessary to guide human behavior in an environment where change is pervasive and to shape a society in which inequities and coercion are minimized and human dignity is ensured.

As dean, Bob Yegge initiated innovative and far-reaching measures to realize his vision of legal education at the University of Denver College of Law. As a result the past decade has witnessed both a reevaluation of legal education at the College of Law and a significant outreach by the College into the court system, the legislature, and the community. The serious student of the law is now exposed not only to the rigors of the traditional legal education—the teaching of doctrines, skills, and policy in the classroom setting designed to instill lawyerly thinking—but also to the stark realities of the human condition in the prisons, hospitals, drug treatment centers, court chambers, and the corridors of the state house. Thus, practical first hand exposure to contemporary problems of law and legal policy supplements the classroom and the library. If one were forced to choose one principal legacy of Bob Yegge's helmsmanship, it would necessarily be the nationally recognized, pacesetting clinical approach to legal education which has become a unique "Denver Law School approach" during his brief tenure. The students have been and will continue to be the principal beneficiaries of Dean Yegge's creative response to complex societal needs.

His student years at Princeton and Denver, further enriched by private practice, part-time teaching, scholarly writing, and a close community involvement, had prepared Bob Yegge well for his role as dean of a college of law in a metropolitan setting. Early in his deanship in 1966, he made a tripartite commitment to the faculty of the College of Law—that the College of Law must be a place for teaching the accumulated traditions of the law and awakening the imagination of future practitioners to tomorrow's problems; that the College of Law must be a research center in the entire spectrum of law and the social sciences to support research necessary to meet the challenges facing the legal profession in the stormy years ahead; and, that the College of Law must be an active member of the community, a leader in community involvement and in community action.

Even a slight acquaintance with the College of Law in 1977-78 will show Dean Yegge's success in accomplishing these goals. During the past decade, a remarkable change has occurred in the teaching environment at the College of Law. The number of law students has doubled. The College has been a national leader in promoting equal opportunities for women and minority groups in entering the bar. The full-time faculty has grown from a meager eleven to more than thirty. As the statistics have changed, so has the curriculum. Expanded opportunities for specialization, clinical education, interdisciplinary joint degrees, and graduate legal education are now commonly available at the Law Center. Reputable graduate programs provide opportunities for study in Master of Laws in Taxation, Master of Science in Law and Society, and Master of Science in Judicial Administration. Joint Degree programs are offered in conjunction with the College of Business, the Graduate School of International Studies, the Graduate School of Librarianship, the Graduate School of Social Work, and many departments in the College of Arts and Sciences as well as with the Colorado School of Mines. The Natural Resources Program is of the premier class; the Program in Transportation Law is unique among American law schools and arose as part of a relationship between Dean Yegge and the Motor Carrier Lawyers Association. The International Legal Studies Program, actively supported by the Dean, now offers more than a dozen courses and seminars and continues to make its impact felt far beyond our national borders. First established by Dean Yegge, the Administration of Justice Program utilizes interdisciplinary faculty and research techniques in dealing with the multiple aspects of the effective delivery of legal services to our young, elderly, poor, and culturally disadvantaged.

The exceptional amount of independent research and writing conducted at the Law Center in the last few years has allowed the faculty and students to make significant contributions to the advancement of twentieth century legal thought. Major studies and pilot projects have been completed in many fields, including international law, environmental law, commercial law including corporate law and securities, criminal law and procedure, litigation, administrative and constitutional law, poverty law, family law, clinical education, counselling and negotiations, intellectual property law, sports law, legal curriculum, legal profession, and in the use of paralegal personnel. Clearly, Dean Yegge's commitment to the establishment of quality in institutional research has been significantly realized.

Bob Yegge's sensitivity to the needs of the community and the law school's role in meeting those needs has had a dynamic impact in Colorado, the Rocky Mountain Region, and national thinking about American legal education. While the Clinical Programs have sharply increased the Law Center's visibility in the community, Dean Yegge has also played a pivotal role in assisting the legal profession to meet the new challenges posed by a technocracy where complacency would surely foreshadow defeat. Thus, the Program for Advanced Professional Development which he fashioned and nurtured is one of the most active in the nation and is built on the assumption that lawyers need to be learners all their lives if the profession is to adequately meet its societal obligations. The community demands and deserves continuing professional competence, and the College of Law is committed to assume a role of leadership in providing proper educational opportunities toward this end.

As specialists and experts in different fields of law and social sciences, members of the faculty have made significant contributions as teachers and scholars. The impact of their written and spoken words has been felt not only in the State of Colorado and the United States, but in the international community as well. The credit for creating first the environment which made it possible to attract these people at the University of Denver and secondly the intellectual fervor at the College of Law which has kept them here goes to Bob Yegge.

"Contributing" has always been an adjective of common usage when describing Bob Yegge. He clearly exemplifies the professional with the keen sense of public responsibility and the ethical instincts so vital to a profession which has been subjected to a frontal assault on its integrity in the wake of scandals at the highest levels of government. His professional activities at the national, regional, and local levels are too extensive to recount fully here. Suffice it to say that his counsel and advice have been sought and freely given to national bar organizations, governmental agencies, the judiciary, professional and research organizations and publications, institutes of higher education, public interest and art and culture forums, foundations, and charitable organizations. Society, in turn, has bestowed a plethora of honors and awards upon Dean Yegge for his exemplary contributions in many diverse areas of civic performance.

His scholarship is on a level equal to that of his civic performance. He has published numerous works in a wide variety of areas including commercial law, jurisprudence, criminal law and procedure, legal education, the legal profession, legal services, paraprofessionals, torts, civil procedure, civil rights, law and technology, consumer law, and judicial administration. His numerous books, monographs, and contributions to professional journals reflect his broad intellectual capacity.

While one could easily document the significant and extensive impact of Robert Yegge's deanship upon legal education in Denver and elsewhere, and others will, this personal note needs to be added, lest we would miss the true value of his presence at the College of Law.

In an age where responsibility is often lost in bureaucratic mazes and integrity is compromised by the politics of the moment, Robert Yegge stands out, personifying not only responsibility and integrity, but also courage, creativity, and imagination. He is leaving the College of Law with the same dynamic energy with which he arrived. His friends wish him well in his new ventures.

Ved P. Nanda
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INFORMAL RULEMAKING: IN QUEST OF NUCLEAR LICENSING REFORM

BY JAMES WILLIAM BAIN*

In recent years, efforts to reform the nuclear licensing process have generally been unsuccessful. The last significant effort was made by the Atomic Energy Commission in August of 1972 when the restructured rules of practice were adopted.[1] These rules, designed to make licensing more efficient, did not accomplish their purpose. Delays have continued and have even increased so that today nuclear power plants have become a less attractive alternative for producing energy—not because of public health and safety considerations and not because of environmental impacts but because of the ever-increasing time needed to license and construct a nuclear plant.[2] Legislation providing comprehensive, fundamental reforms in nuclear licensing is desirable; however, it may not happen soon.[3] If it does not, what can the industry

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[1] 37 Fed. Reg. 15,127 (1972).

[2] In the period of 1963 and 1964 when the first large nuclear plants were ordered, the average time between the filing of a construction permit application and the granting of the permit was 9 months. In 1970, this application time increased to 20 months and has since risen to 41 months in 1977 and is continuing to rise. This delay has continued to increase even though the early plants represented innovative technology, whereas the technology of the current plants has remained stable for years. This delay is a direct result of the growing regulatory load. The Atomic Industrial Forum's licensing review group recently concluded that the current licensing process itself adds fours or five years to the overall project time. For example, in 1972, nuclear plants were subject to 32 Regulatory Guides (a report promulgated by the NRC Regulatory Staff which, although not legally binding as a regulation, outlines acceptable methods for implementing NRC's regulations); this number was doubled in 1973; and the number has continued to increase at an astounding rate. Presently 250 Regulatory Guides and Branch Technical Positions are either in existence or under development. As a consequence, the period now required to construct a large nuclear power plant can extend over 12 years.

[3] The long-awaited legislative nuclear licensing reform proposal by President Carter, H.R. 11704 and S. 2775, 95th Cong., 2d Sess. (1978), has not yet emerged from either the House (Science and Technology, Interior and Insular Affairs, and Interstate and Foreign

itself do to initiate reforms? Industry should consider engaging in some self-help. Rulemaking, largely neglected as a reform technique, may provide an opportunity for this self-help. In order to effectively utilize rulemaking, new trends in the law must be recognized, understood, and applied.

Courts required administrative agencies, including the Nuclear Regulatory Commission (NRC),[4] to adopt adjudicatory procedures in informal rulemaking proceedings. The requirements of due process[5] and the applicable provisions of the Administrative Procedure Act (APA)[6] provided no firm foundation for the impo-

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Commerce) or Senate (Environment and Public Works) Committees which are considering it. Additionally, the House Subcommittee on Energy and the Environment indicated that it will substantially revise the bill before it is reported to the full committee.

[4] The Energy Reorganization Act of 1974, 42 U.S.C. § 5801 (Supp. V 1975), abolished the Atomic Energy Commission (AEC) and divided its duties between the Nuclear Regulatory Commission (NRC) and the Energy Research and Development Administration (ERDA). NRC received the licensing and related regulatory functions of the AEC. The Atomic Energy Act of 1954, *as amended*, 42 U.S.C. §§ 2011-2296 (1970 & Supp. V 1975), outlines NRC's powers and duties. Hereafter, the AEC and the NRC may be jointly referred to as the Commission.

[5] *See* California Citizens Band Ass'n v. United States, 375 F.2d 43 (9th Cir. 1967); Superior Oil Co. v. FPC, 322 F.2d 601 (9th Cir. 1963), *cert. denied*, 377 U.S. 922, *rehearing denied*, 377 U.S. 960 (1964). The Constitution does not mandate an across-the-board right to oral argument in administrative proceedings. FCC v. WRJ, 337 U.S. 265 (1949). The Supreme Court has held that the requirement of an opportunity for oral argument varies from case to case in accordance with differing circumstances, as do other procedural requirements; in some cases it is essential to due process, Londoner v. Denver, 210 U.S. 373 (1908), while in other situations opportunity for submitting written comments is sufficient, Morgan v. United States, 298 U.S. 468 (1936). This distinction arises from the difference between adjudication, in which a small number of persons are "exceptionally affected, in each case upon individual grounds" and rulemaking in which policy-type rules generally affecting a large number of persons are promulgated. Bi-Metallic Inv. Co. v. State Bd. of Equalization, 239 U.S. 441, 445-46 (1915). The Supreme Court recently cited the *Bi-Metallic* distinction with approval and reemphasized that the due process clause recognizes the distinction between "proceedings for the purpose of promulgating policy-type rules or standards, on the one hand, and proceedings designed to adjudicate disputed facts in particular cases on the other." United States v. Florida E. Coast Ry., 410 U.S. 224, 244-45 (1973).

When rules of general applicability are involved, *Bi-Metallic* indicates that the Constitution imposes no procedural constraints upon the agency. *Bi-Metallic, supra* at 445. *But cf.* Appalachian Power Co. v. EPA, 477 F.2d 495, 503 (4th Cir. 1973) (where due process did not require that administrator afford hearings prior to approving state air quality plan). This conflict is epitomized by the important due process concept that the practical needs of effective government must be balanced against the need to protect individuals against unfair official action. *See, e.g.*, Richardson v. Perales, 402 U.S. 389 (1971); Goldberg v. Kelly, 397 U.S. 254 (1970).

[6] Administrative Procedure Act, ch. 324, 60 Stat. 237 (1946), *as amended*, Pub. L. No. 89-544, 80 Stat. 378 (1966) (codified in scattered sections of 5 U.S.C.).

sition of these procedures, but were used as a judicial springboard for them. Courts, starting with the express APA requirements and the requirements of fundamental fairness, engaged in creative lawmaking by basing their holdings on the necessities of adequate judicial review. In addition to this putative reason for imposing such procedures, there were other basic and often unstated reasons: constriction of administrative discretion and the necessity of making factual determinations in informal rulemaking proceedings. These three factors, acting synergistically, led to an expansive interpretation of the APA requirements for informal rulemaking. Although the Supreme Court recently reversed a decision imposing adjudicatory procedures in an informal rulemaking context,[7] the Court presented no resolution of the underlying problems which caused the Court to impose the procedures. These problems must be understood if one is to comprehend where rulemaking was, where it is, and where it is going.

Reform of the nuclear licensing process through informal rulemaking provides the impetus for this article. It will outline the law concerning rulemaking, how it was recently changed, and the reasons why courts required administrative agencies to adopt procedures in excess of traditional rulemaking requirements. Finally, the article will demonstrate how the nuclear power industry can utilize rulemaking to accomplish its purpose.

I. BACKGROUND

The Atomic Energy Act of 1954[8] grants the NRC the authority to "make, promulgate, issue, rescind, and amend such rules and regulations as may be necessary to carry out the purposes of this [Act]."[9] Rulemaking has been the primary method chosen by the NRC to interpret its obligations under the Atomic Energy Act and the National Environmental Policy Act.[10] Once passed,

[7] Vermont Yankee Nuclear Power Corp. v. Natural Resources Defense Council, Inc., No. 76-419 (Sup. Ct. April 3, 1978), *rev'g* Natural Resources Defense Council v. NRC, 547 F.2d 633 (D.C. Cir. 1976).

[8] 42 U.S.C. §§ 2011-2296 (1970 & Supp. V 1975).

[9] *Id.* at § 2201(p) (1970).

[10] 42 U.S.C. §§ 4321-4347 (1970 & Supp. V 1975). This act requires all federal agencies to evaluate environmental impacts by utilizing "a systematic, interdisciplinary approach" of "major Federal actions significantly affecting the quality of the human environment." 42 U.S.C. § 4332(2)(C) (1970). The Court of Appeals for the District of Columbia in the seminal case of Calvert Cliffs' Coordinating Comm. v. AEC, 449 F.2d 1109 (D.C. Cir. 1971), held that in order for the NRC to comply with NEPA, it must review both radiological environmental issues.

rules and regulations adopted in informal rulemaking proceedings have the force of law.[11] Both the APA[12] and the NRC's regulations[13] grant "interested persons" the right to petition for the issuance, amendment, or repeal of a rule. The courts of appeals have exclusive jurisdiction to "enjoin, set aside, suspend (in whole or in part), or to determine the validity of . . . all final orders"[14] "for the issuance or modification of rules and regulations"[15] of the NRC.

The APA provides the format for administrative lawmaking by the NRC under the Atomic Energy Act.[16] Two alternative types of procedures for the promulgation of rules are expressly established by the APA. One, known as "formal" rulemaking,[17] closely resembles adjudication[18] and is only required to be utilized in a limited number of circumstances.[19] Formal rulemaking is only required where the authorizing legislation requires the rules

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[11] *See* Yiatchos v. Yiatchos, 376 U.S. 306, 309 (1964).

[12] 5 U.S.C. § 553(e) (1976).

[13] 10 C.F.R. § 2.805(b) (1977).

[14] 28 U.S.C. § 2342(4) (Supp. V 1975).

[15] 42 U.S.C. § 2239 (1970). Jurisdiction may be obtained by any party aggrieved by the order who files a petition in accordance with 28 U.S.C. § 2344 (1970). Alternatively, an aggrieved party may obtain jurisdiction under 28 U.S.C. § 1331(a) (1970), which has been amended to eliminate the requirement of a specified amount-in-controversy as a prerequisite to the maintenance of any "action brought against the United States, any agency thereof, or any officer or employee thereof in his official capacity." Pub. L. No. 94-574, § 703, 90 Stat. 2721 (1976). The Supreme Court has interpreted the effect of this modification as conferring authority on federal courts to review agency action regardless of whether the APA may itself serve as a jurisdictional predicate. Califano v. Sanders, 430 U.S. 99 (1977).

[16] 42 U.S.C. § 2331 (1970). This section also authorizes the Commission to promulgate regulations providing for parallel procedures designed to safeguard and prevent disclosure of restricted data or defense information.

[17] 5 U.S.C. §§ 556-557 (1976) (hereinafter also referred to as "sections 556-557").

[18] The APA requires essentially the same procedures for formal rulemaking as for adjudication, as in both cases there is a hearing with a right of cross-examination before an administrative judge. 5 U.S.C. § 556(b) (1976). Some differences exist, however, including allowing settlements in adjudications, 5 U.S.C. § 554(c)(1) (1976); allowing all or part of the evidence to be submitted in written form in rulemaking when a party will not be prejudiced thereby, 5 U.S.C. § 556(d) (1976); allowing the decision of the hearing examiner to be omitted because rulemaking is not subject to 5 U.S.C. § 554 (1976); and not applying the separation of functions requirement of 5 U.S.C. § 554(d) (1970) to rulemaking.

[19] Hamilton, *Procedures for the Adoption of Rules of General Applicability: The Need for Procedural Innovation in Administrative Rulemaking*, 60 CALIF. L. REV. 1276, 1278 (1972). *See generally* Verkuil, *A Study of Informal Adjudication Procedures*, 43 U. CHI. L. REV. 739 (1976).

to be made "on the record after opportunity for an agency hearing."[20] The second rulemaking provision, "informal" or "notice and comment" rulemaking,[21] requires no formal hearing and is applicable to the great bulk of rulemaking authority bestowed on Federal agencies.

Section 553 prescribes three obligations for the rulemaking agency. First, public notice must be published in the *Federal Register* stating the time, place, and nature of the proceedings, "the legal authority under which the rule is proposed," and "either the terms of substance of the proposed rule or a description of the subjects and issues involved."[22] Second, interested persons must be granted "an opportunity to participate in the rulemaking through submission of written data, views, or arguments with or without opportunity for oral presentation."[23] Finally, the agency must "incorporate in the rules adopted a concise general statement of their basis and purpose."[24]

Because of the relative informality of section 553 procedures and the extreme costliness in time, staff, and money of sections

[20] The Supreme Court interpreted this hearing requirement in United States v. Florida E. Coast Ry., 410 U.S. 224 (1973). This case concerned the power of the Interstate Commerce Commission (ICC) to promulgate incentive per diem rates under the Interstate Commerce Act,which provides that the rate prescription should be be made only "after hearing." 49 U.S.C. § 1(14)(a) (1970). The ICC promulgated the rates after publishing a notice and soliciting comments on proposed rule. The Court held that section 1(14)(a) was not the equivalent of a requirement that the rule be made "on the record after opportunity for an agency hearing" as the APA requires to make the hearing requirements of sections 556-557 applicable. Rather, the ICC's rulemaking proceeding was governed by section 553 of the APA, which authorizes an agency to restrict interested parties to the submission of written evidence and argument without oral presentation and, accordingly, upheld the ICC's rule. The Court reasoned that, despite the paucity of statutes where the words "on the record" or their equivalent appear, courts are obligated to adhere to the congressional language and must find the requisite phrase before directing the application of sections 556-557. The Court in effect rendered the Interstate Commerce Act's express requirement of a "hearing" nugatory, as section 553 would have required these minimal procedures even if the act had been silent.

Despite the inapplicability of sections 556-557 in these circumstances, the Court did not rule out such application in all statutes which do not prescribe *in haec verba* that the hearing be "on the record," nor did the Court elevate this phrase to *sine qua non* status. 410 U.S. at 238. However, after *Florida E. Coast Ry.* it is unlikely that a court would require a formal rulemaking proceeding when the statute calls for a "hearing", unless the statute is unmistakably clear, as by the addition of "on the record," or unless the legislative history clearly provides for such a proceeding.

[21] 5 U.S.C. § 553 (1970) (hereinafter referred to as "section 553").

[22] 5 U.S.C. § 553(b)(1)-(3) (1976).

[23] 5 U.S.C. § 553(c) (1976).

[24] *Id.*

556-557 procedures, the vast majority of administrative agencies utilize informal rulemaking. The Supreme Court has demonstrated its reluctance to prescribe formal rulemaking procedures.[25] The ponderousness of formal rulemaking renders innovation difficult, allows exigencies to often go unmet, and fosters changed conditions prior to the completion of the proceeding. These factors cause the industries which are subject to adjudicatory regulation to be left in a state of perpetual uncertainty.[26] By contrast, informal rulemaking combines the advantages of legislative decisionmaking with some of the requirements of an adjudicatory proceeding. The agency is not limited to a decision based entirely on a carefully delineated record; rules can be promulgated efficiently and expeditiously and a broad base of public participation is encouraged because participation may be in written or oral form without the necessity of undergoing prolonged cross-examination. While these formidable advantages are widely recognized, at some point the wide range of discretion committed to the administrator gives cause for alarm. Nonagency participants have had the impression that this very flexibility and lack of adjudicatory safeguards have denied them a "full hearing."[27]

The Atomic Energy Act does not mandate a hearing "on the record" either on its face or as judicially construed.[28] Accordingly, the Commission took the position early that formal rulemaking procedures were not required by the Atomic Energy Act.[29] Despite

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[25] *Cf.* United States v. Florida E. Coast Ry., 410 U.S. 224 (1973); United States v. Allegheny-Ludlum Steel Corp., 406 U.S. 742 (1972).

[26] This was the position of the utilities regulated by the Federal Power Commission (FPC) prior to the Permian Basin Area Rate Cases, 390 U.S. 747 (1968), which allowed more informal rulemaking procedures and allowed the FPC to set rates for an entire area in one proceeding.

[27] *See, e.g.*, American Pub. Gas Ass'n v. FPC, 498 F.2d 718 (D.C. Cir. 1974); Siegal v. AEC, 400 F.2d 778 (D.C. Cir. 1968).

[28] *See* Siegal v. AEC, 400 F.2d 778 (D.C. Cir. 1968), wherein the Court of Appeals for the District of Columbia upheld the Commission's use of informal rulemaking procedures. The court explained section 553 as follows:

> This language seems to say, and has been read by an authoritative source as saying, that the formal procedures of Sections 7 and 8 [of the APA] obtain only where the agency statute, in addition to providing a hearing, prescribes explicitly that it be "on the record." [Here the court cited page 314 of the Attorney General's Manual on the Administrative Procedure Act (1947) in a footnote.] There is no such prescription in the Atomic Energy Act, either in terms or by clear implication . . . .

Id. at 785.

[29] *See* STAFF OF THE JOINT COMM. ON ATOMIC ENERGY, 87th Cong., 1st Sess., 2

the absence of a statutory obligation, the Commission has on occasion granted extensive procedural rights to afford the public an opportunity for more significant participation.[30] Such participation can generate public confidence in rulemaking and can facilitate the representation of otherwise neglected values.[31] Judicial recognition of the public's role has fostered the gradual erosion of the restrictive standing doctrine, which had previously curtailed the public's intervention.[32]

II. HYBRID RULEMAKING AND ITS UNDERLYING FACTORS

Both courts[33] and commentators[34] have advocated that the APA's strict dichotomy between formal and informal rulemaking should yield to a more flexible analysis which would be guided by considerations of due process and public policy and which would produce *ad hoc* procedures tailored to fit each rulemaking scenario. The courts are confronted with a dilemma in this area: they must effectively perform their reviewing role and therefore require explanations and reasons for the agency's actions;[35] but they must recognize that the rulemaker should not be circumscribed by onerous, time-comsuming adjudicatory encumbrances[36] and that the courts should not substitute their decision for the agency's.[37] As a potential solution to this problem, some courts compelled agencies to afford opponents of a rule substantial pro-

IMPROVING THE AEC REGULATORY PROCESS 149 (Comm. Print 1961).

[30] *See* Freeman, *The AEC's Recent Experiment in "Evidentiary" Rule Making*, 28 BUS. LAW. 663 (1973).

[31] Johnston, *AEC Rulemaking and Public Participation*, 62 GEO. L.J. 1737 (1974).

[32] *See, e.g.*, Association of Data Processing Serv. Organizations v. Camp, 397 U.S. 150, 153 (1970) (standing to seek judicial review need not flow from any express Congressional grant); Barlow v. Collins, 397 U.S. 159, 165 (1970) (a court must determine whether Congress precluded judicial review); Office of Communication of United Church of Christ v. FCC, 359 F.2d 994, 1000-01 (D.C. Cir. 1966) (standing does not require the assertion of an economic interest); Scenic Hudson Preservation Conference v. FPC, 354 F.2d 608, 616 (2d Cir. 1965), *cert. denied*, 384 U.S. 941 (1966) (aesthetic or environmental interest is sufficient to confer standing). *But cf.* Easton Utils. Comm'n v. AEC, 424 F.2d 847, 850-53 (D.C. Cir. 1970) (untimely application to intervene precludes standing).

[33] *See, e.g.*, Mobil Oil Corp. v. FPC, 483 F.2d 1238, 1251-54 (D.C. Cir. 1973).

[34] *See, e.g.*, Clagett, *Informal Action—Adjudication—Rule Making: Somme Recent Developments in Federal Administrative Law*, 1971 DUKE L.J. 51, 85-88.

[35] *See* SEC v. Chenery Corp., 318 U.S. 80, 94 (1943).

[36] *See* Vermont Yankee Nuclear Power Corp. v. Natural Resources Defense Council, Inc., No. 76-419 (Sup. Ct. April 3, 1978); International Harvester Co. v. Ruckleshaus, 478 F.2d 615, 631 (D.C. Cir. 1973).

[37] Citizens To Preserve Overton Park v. Volpe, 401 U.S. 402, 416 (1971).

cedural protections by mandating adjudicatory procedures despite the absence of an "on the record" hearing requirement.[38] Several of these cases did not place their brands of rulemaking anywhere within the APA classification;[39] rather, this procedural imposition was labeled "hybrid rulemaking."[40] The Supreme Court in *Vermont Yankee Nuclear Power Corp. v. Natural Resources Defense Council, Inc.*[41] stayed the judicial hand which mandated adjudicatory procedures in informal rulemaking contexts. Although courts may no longer impose rigorous procedural requisites upon the rulemaking process, the factors which prompted this judicial response still exist and will continue to influence judicial review of agency actions. To fully understand this area of the law and to comprehend the significance of the Supreme Court's recent landmark case, the three primary factors underlying hybrid rulemaking must be understood. These factors are outlined in the next three subsections. The fourth subsection demonstrates how these factors were used to expand the scope of section 553.

A. *Constriction of Administrative Discretion*

Agencies, unlike courts, have express authority to make law prospectively through the exercise of rulemaking power and have commensurately less need or reason to rely on *ad hoc* adjudication in formulating new standards.[42] Although all potential problems cannot be handled through rulemaking, agencies should strive towards filling the interstices in their authorizing statutes through the promulgation of rules.[43] Rules have the salutary effect of exposing agency policy to public scrutiny, whereas case-by-case adjudication, with its limited effect and restricted participa-

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[38] *See* text accompanying notes 161-176, *infra*.

[39] *See* Public Serv. Comm'n v. FPC, 487 F.2d 1043, 1069 (D.C. Cir. 1973) (declining to reach classification problem); Appalachian Power Co. v. EPA, 477 F.2d 495, 500 (4th Cir. 1973) (discarding APA classifications for determining the type of hearing required); Walter Holm & Co. v. Hardin, 449 F.2d 1009 (D.C. Cir. 1971) (basing the impositions of procedural requirements on considerations of "fairness").

[40] *See, e.g.*, Williams, *"Hybrid Rulemaking" Under the Administrative Procedure Act: A Legal and Empirical Analysis*, 42 U. CHI. L. REV. 401 (1975).

[41] No. 76-419 (Sup. Ct. April 3, 1978).

[42] SEC v. Chenery Corp., 332 U.S. 194, 202 (1947).

[43] *Id.* Commentators have also exhorted agencies to make greater use of rulemaking. *See, e.g.*, Fuchs, *Agency Development of Policy Through Rulemaking*, 59 NEV. U.L. REV. 781 (1965); Shapiro, *The Choice of Rulemaking or Adjudication in the Development of Administrative Policy*, 78 HARV. L. REV. 921 (1965).

tion, often does not.[44] Absent promulgation of rules, administrative actions are often chaotic and inequitable because neither the parties nor the administrators know what standard is to be applied.[45] In recognition of these factors, agencies which had previously promulgated policy in *ad hoc* piecemeal fashion through adjudication are now adopting prospective policy standards, rules, and regulations, which apply generically to a variety of parties in eclectic situations. The pattern of promulgating regulations is especially prominent in the agencies entrusted with environmental and energy problems.[46]

Many statutes, such as the Atomic Energy Act, merely establish a legislative framework within which the administrator enjoys broad discretion when promulgating rules.[47] Congress, in recognizing this fact, evinced serious misgivings about agencies utilizing minimum notice and comment rulemaking procedures. During the last decade, many statutes have required procedures in excess of minimum notice and comment rulemaking procedures.[48] These contrast with most older statutes which do not impose any procedural requirements for rulemaking.[49]

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[44] *See* Wright, *Court of Appeals Review of Federal Regulatory Agency Rulemaking*, 26 AD. L. REV. 199, 202 (1974).

[45] *See generally* Friendly, *The Federal Administrative Agencies: The Need for Better Definition of Standards*, 75 HARV. L. REV. 863 (1962).

[46] That both Congress and the agencies emphasize and favor rulemaking over adjudication as the most efficient and useful means of promulgating administrative policy is demonstrated by the statutory authority bestowed upon the Environmental Protection Agency (EPA). EPA has been specifically authorized to establish, in conjunction with state governments, comprehensive standards for pollution control by focusing on broad environmental questions involving different pollutants in diverse industries and areas. *See* Federal Water Pollution Control Act amendments, Pub. L. No. 95-217, 91 Stat. 1567 (1977) (codified at 33 U.S.C. §§ 1251-1265 (Supp. V 1975)); Clean Air Act amendments, Pub. L. No. 95-95, 91 Stat. 685 (1977) (codified at 42 U.S.C. §§ 7401-7642 (1976)). Similarly, the NRC has been prolific in the promulgation of rules, regulations, and standards. *See* 10 C.F.R. §§ 0-170 (1977).

[47] The court in Siegal v. AEC, 400 F.2d 778 (D.C. Cir. 1968), stated: "Congress agreed by enacting a regulatory scheme which is virtually unique in the degree to which broad responsibility is reposed in the administrative agency, free of close prescription in its charter as to how it shall proceed in achieving the statutory objectives." *Id.* at 783. *See also* Power Reactor Dev. Co. v. International Union of Electrical Workers, 367 U.S. 396 (1961).

[48] Hamilton, *Procedures for the Adoption of Rules of General Applicability: The Need for Procedural Innovation in Administrative Rulemaking*, 60 CALIF. L. REV. 1276 (1972).

[49] *Id.* at 1278. Of course, the APA's procedures apply to rulemaking under these statutes.

Rulemaking protects the rights of individual parties by circumscribing unguided discretionary power to decide individual cases.[50] Similarly, in some cases, the broad discretion to fashion generally applicable rules must be subject to some restraint. If only notice and comment procedures are used, the record is ordinarily so unfocused and ponderous that the administrator could find support for choosing any of the alternatives offered.[51]

Courts, in refusing to blindly rely upon the unstructured exercise of administrative discretion,[52] have required agencies to clarify decisionmaking standards, to consistently apply these standards to guide their decisions, and to state findings of fact and the reasons for decisions. The courts, demonstrating their uneasiness about the extent of administration discretion, have felt that justice requires judicial intervention to circumscribe unnecessary and uncontrolled discretionary power.[53] However, in any endeavor to circumscribe agency action, the court must fully allow for the reality that agency matters typically involve some quantum of expert discretion.[54] Expertise may form a legitimate basis for rules resolving questions of policy, but it cannot justify procedural inadequacy in factual controversies. Expertise is strengthened in its proper role when it is denied the opportunity to "become a monster which rules with no practical limits on its discretion."[55]

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[50] *See* Holmes v. New York City Housing Auth., 398 F.2d 262 (2d Cir. 1968); Hornsby v. Allen, 326 F.2d 605 (5th Cir. 1964).

[51] *See* City of Chicago v. FPC, 458 F.2d 731, 744 (D.C. Cir. 1971), *cert. denied*, 405 U.S. 1074 (1972).

[52] *See* Environmental Defense Fund Inc. v. Ruckelshaus, 439 F.2d 584, (D.C. Cir. 1971), wherein the court stated that:

> Judicial review must operate to ensure that the administrative process itself will confine and control the exercise of discretion. Courts should require administrative officers to articulate the standards and principles that govern their discretionary decisions in as much detail as possible . . . . Discretionary decisions should more often be supported with findings of fact and reasoned opinions.

Id. at 598.

[53] *See generally* K. DAVIS, DISCRETIONARY JUSTICE—A PRELIMINARY INQUIRY (1969). Professor Davis has argued that arbitrary administrative action can be effectively restricted only by requiring agencies to formalize their policies in clear rules of prospective application.

[54] *See* NLRB v. Brown, 380 U.S. 278, 290-92 (1965); Braniff Airways, Inc. v. CAB, 379 F.2d 453 (D.C. Cir. 1967).

[55] Greater Boston Tel. Corp. v. FCC, 444 F.2d 841, 850 (D.C. Cir. 1970) (quoting Burlington Truck Lines v. United States, 371 U.S. 156, 167 (1962)).

B. *Factual Determinations in Informal Rulemaking*

Three types of questions are raised in rulemaking proceedings: policy questions, factual questions, and interdependent questions of policy and fact. Although many of the issues presented to the NRC are primarily technical, other issues involve trade-offs between competing values and judgments of broad social and environmental import. Resolution of such policy questions denigrates the significance of detailed factual investigation and minimizes the need for the constraints afforded by the procedural protection of an adjudicatory hearing.[56] Policy issues disguised as scientific problems should not be consigned to technical experts nor decided by administrators and reviewing judges, but should be directly confronted as questions of policy by the elected representatives of the people. However, in the absence of congressional action, policy issues must be decided in rulemaking proceedings open to broad public scrutiny. This is the type of issue which pure notice and comment procedures were designed to resolve.

Conversely, adjudicatory procedures work best with narrowly defined factual issues.[57] Informal rulemaking is handicapped in its fact-resolution endeavors by the absence of a clearly defined mechanism to sift the many topics addressed in the comments; such sifting would occur if testimony was shaped by witnesses subject to cross-examination. Hybrid rulemaking decisions attempted to diminish informal rulemaking's fact-finding inadequacies by mandating the application of the traditional methods relied on by Anglo-American jurisprudence to ensure accuracy in adversarial proceedings—adjudicatory procedures,[58] including cross-examination with its unique potential as an "engine of truth."[59] Of course, after *Vermont Yankee,* this is no longer a

[56] *See* Williams, *"Hybrid Rulemaking" Under the Administrative Procedure Act: A Legal and Empirical Analysis,* 42 U. CHI. L. REV. 401, 408 (1975).

[57] *See* Hamilton, note 48 *supra,* at 1313. *Cf.* Cramton, *A Comment on Trial-Type Hearings in Nuclear Power Plant Siting,* 58 VA. L. REV. 585, 586 (1972).

[58] *See* Verkuil, *A Study of Informal Adjudication Procedures,* 43 U. CHI. L. REV. 739, 743 (1976).

[59] International Harvester Co. v. Ruckelshaus, 478 F.2d 615, 631 (D.C. Cir. 1973). Commentators are divided over cross-examination's utility in resolving factual matters in administrative proceedings. *Compare* Robinson, *The Making of Administrative Policy: Another Look at Rulemaking and Adjudication and Administrative Procedure Reform,* 118 U. PA. L. REV. 485, 522 (1970) ("cross-examination can serve a more valuable function

viable option.[60] Courts are now limited to examining the factual

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in testing forecasts and generalized conclusions underlying future policy planning than in making findings concerning specific past events"), *with* Homburger, *Functions of Orality in Australian and American Civil Procedure*, 20 BUFFALO L. REV. 9, 36 (1970) ("If cross-examination really is the 'greatest engine ever invented for the discovery of truth,' one wonders why other legal systems have not imported that fabulous 'engine' ").

[60] The Court set forth a number of policy reasons for refusing to allow courts to impose adjudicatory procedures on administrative agencies. In order to evaluate the effect of the Court's opinion, these reasons must be examined. First, the Court reasoned that if courts are allowed to review agency proceedings to determine whether the agency employed the "best" procedures, judicial review would be totally "unpredictable." No. 76-419, slip op. at 24 (Sup. Ct. April 3, 1978). The reasoning underlying this reason is hard to fathom; judicial review should be no more "unpredictable" if additional procedures are available as a remedy. None of the hybrid rulemaking cases mandated a particular procedure—they required a system of procedures as a means of developing an "adequate record." If an agency develops a record without utilizing such procedures, it could nevertheless be adequate. Such procedures should be permissible if they are used as a tool to remedy a perceived inadequacy, but not if they are used to evaluate the agency's proceeding. Judge Friendly places this debate into perspective:

> It is thus not too consequential whether a court invalidates a rule on the ground that the procedures have not developed substantial evidence to support it or even evidence adequate to rebut a claim that it is arbitrary and capricious, or, instead, takes the route of prescribing ad hoc procedural requirements in addition to those of section 553. Although the former course seems more in keeping with the statutory language and less likely to promote undue judicial activism, the practical result is much the same. Both roads lead to the conclusion that an administrator engaged in rulemaking governed by the APA cannot always be sure that rudimentary notice and comment procedures . . . will always suffice.

Friendly, *Some Kind of Hearing*, 123 U. PA. L. REV. 1267, 1314 (1975). The Court also fears that if agencies are forced to operate under such a "vague injunction," they "would undoubtedly adopt full adjudicatory procedures in every instance," thus losing all the inherent advantages of informal rulemaking. No. 76-419, slip op. at 24 (Sup. Ct. April 3, 1978). This concern, although possessing superficial validity is in part untrue and in part exaggerated. Courts mandating hybrid procedures granted agencies discretion in adopting procedures so long as "reasoned decisionmaking" was assured. There would be no need for an agency to adopt full adjudicatory procedures for the limited-effect, noncontroversial rules that compose the bulk of rulemaking proceedings. The Court recognizes this fact in its opinion when it states: "Since 1970 [after American Airlines, Inc. v. CAB, 359 F.2d 624 (en banc), *cert. denied*, 385 U.S. 843 (1966), the seminal case in hybrid rulemaking] the Commission has conducted a large number of rulemaking proceedings, some of which involved matters of substantial importance, and almost none of which involved cross-examination." No. 76-419, slip op. at 21 n.17 (Sup. Ct. April 3, 1978). Although during this time period NRC had not been required to adopt such procedures, other agencies had been so ordered, and it was not unforeseeable that a court would order NRC to use similar procedure in a future situation.

The Court gives as its third reason the fact that agency procedures cannot be looked at with hindsight; rather, the procedures must be evaluated on the basis of the information available when the procedures were formulated. The final reason presented by the Court is also hard to decipher as it does not fit into any syllogistic pattern. The Court reasoned that informal rulemaking under section 553 does not require an agency to rely exclusively underpinning of a rule without mandating procedures to assist them in this task; the agency itself must determine what type of procedures will ensure an adequate record.

The most difficult issues in NRC rulemakings, however, involve questions of policy and interdependent questions of complex technological and environmental fact for which pure informal rulemaking may not be sufficient.[61] However, across-the-board use of formal rulemaking procedures is unpalatable because that would militate against the advantages of informal rulemaking. Adjudicatory procedures have both advantages and disadvantages depending on the function they are to achieve. Superimposing the adjudicatory model on administrative decisionmaking in a complex scientific and technological scenario exposes the shortcomings of adjudicatory techniques. The NRC has been entrusted with broad powers and multiple functions and is not expected to behave as an impartial umpire presiding over a private dispute.[62] NRC proceedings focus on future, not past, events and their consequences. Most importantly, this type of issue cannot be couched in a form conducive to a simple answer; rather, the NRC must balance competing values when consider-

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on the transcript generated at a hearing, or to hold a formal hearing at all. From these premises the Court concludes that "the adequacy of the record . . . is not correlated directly to the type of procedural devices employed, but rather turns on whether the agency [complied with the APA and other relevant statutes]." *Id.* at 25. The Court could not have meant that using adjudicatory procedures to gather more evidence and to focus the information it received would not make the record more "adequate." Although such procedures may not be necessary to render the record adequate, the "record," regardless of how it is defined, must be more complete after using such procedures. Considering the historical context in which this opinion was written, this reason can only be interpreted as requiring courts to ensure that the agency complied with the statutory minimums without prescribing hearing procedures to generate on-the-record testimony in support of the rule generaged. In light of SEC v. Chenery Corp., 318 U.S. 80 (1943), and its progeny, the Court could not have meant that the agency is not required to take a "hard look" at the major questions before it and to support each major portion of its rule with some data and reasoning. *See, e.g.*, Walter Holm & Co. v. Hardin, 449 F.2d 1009 (D.C. Cir. 1971).

[61] *See* Verkuil, *Judicial Review of Informal Rulemaking*, 60 VA. L. REV. 185, 193 (1974).

[62] In re Cleveland Electric Illuminating Co. (Perry Nuclear Power Plant, Units 1 and 2), ALAB-443, 6 NRC 741, 752 (1977); In Re Consumers Power Co. (Midland Plant, Units 1 and 2), ALAB-123 6 AEC 331, 335 (1973), *rev'd on other grounds sub nom.;* Aeschliman v. NRC, 547 F.2d 622 (D.C. Cir. 1976), *rev'd on other grounds sub nom.;* Vermont Yankee Nuclear Power Corp. v. Natural Resources Defense Council, Inc., No. 76-419 (Sup. Ct. April 3, 1978). *See also* Scenic Hudson Preservation Conference v. FPC, 354 F.2d 608, 620 (2d Cir. 1965), *cert. denied*, 384 U.S. 941 (1966).

ing the vagaries of an uncertain technology applied in a context of scientific dispute.

Perhaps the wisest course in resolving this type of issue is the middle ground in which the agency would use the most efficacious procedure for each type of dispute. No single set of procedures will be appropriate for all NRC rulemakings because of the diversity of issues and the variety of factual and policy questions involved. The NRC should discriminatively use hybrid procedures, so that mundane noncontroversial rules could be promulgated with dispatch, but the NRC would have the option of increasing the quantum of information submitted for more significant rules. What is needed is some pattern of procedures to fully develop the record and to supply the basis of judicial review.[63] This maintains administrative flexibility, but can also be conducive to administrative confusion and delay.[64] As yet, no precise formula for ascertaining the procedural aspects of such proceedings has emerged.

C. *The Requirements of Judicial Review*

The scope of judicial review is outlined in section 10(e) of the APA,[65] which provides that a reviewing court shall set aside agency action found not to meet six separate standards.[66] The APA putatively describes two alternate standards of judicial review: (1) "arbitrary and capricious"[67] in informal rulemaking pro-

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[63] International Harvester Co. v. Ruckelshaus, 478 F.2d 615 (D.C. Cir. 1973).

[64] *See* FitzGerald, *Mobil Oil Corp. v. Federal Power Commission and the Flexibility of the Administrative Procedure Act*, 26 AD. L. REV. 287, 299 (1974).

[65] 5 U.S.C. § 706 (1976).

[66] The reviewing court shall . . . hold unlawful and set aside agency action, findings, and conclusions found to be—(A) arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law; (B) contrary to constitutional right, power, privilege, or immunity; (C) in excess of statutory jurisdiction, authority, or limitations, or short of statutory right; (D) without observance of procedure required by law; (E) unsupported by substantial evidence in a case subject to sections 556 and 557 of this title or otherwise reviewed on the record of an agency hearing provided by statute; or (F) unwarranted by the facts to the extent that the facts are subject to trial de novo by the reviewing court.

Id.

[67] Although no APA provision states expressly the appropriate standard of review for informal rulemaking it is widely assumed that 5 U.S.C. § 706(2)(A) (1976), which states: "The reviewing court shall . . . set aside agency action . . . found to be . . . arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law," is applicable to informal rulemaking. *See* Recommendations of the Administrative Conference of the

ceedings and (2) "unsupported by substantial evidence"[68] when either formal rulemaking is involved or the agency's authorizing legislation requires it.[69] Courts have applied both standards to informal rulemaking.[70]

1. The Traditional Tests

The potential differences between these two standards lie in the review of the agency's factual findings.[71] The Supreme Court has defined the traditional substantial evidence standard as mandating a determination of whether the agency's decision was reasonably supported by the record as a whole.[72] The reviewing court must ensure that evidence used in making predictions was adequately adduced and rationally applied. Exercising review under this test, a court cannot disturb the factfinder's resolution of conflicting evidence merely because it is "clearly erroneous," but can only upset those determinations which are "patently unreasonable."[73] Additionally, courts are less inclined to delve into the

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United States, 1 CFR § 305.74-4 (1977); Automotive Parts & Accessories Ass'n v. Boyd, 407 F.2d 330 (D.C. Cir. 1968).

[68] 5 U.S.C. § 706(2)(E) (1976). ("The reviewing court shall . . . set aside agency action . . . found to be . . . unsupported by substantial evidence." *Id.*).

[69] The introductory clause of section 10, 5 U.S.C. § 701(a)(2) (1976), limits the application of section 10(e) by providing that, "This chapter applies . . . except to the extent that . . . agency action is committed to agency discretion by law." This section means that to some extent agency action may be committed to agency discretion with no judicial review, but that such delegation need not be an all-or-none proposition. A reviewing court may not set aside an agency's decision to the extent that discretion is committed to the agency. This has been held to be a narrow exception and is applicable only in those rare instances where "statutes are drawn in such broad terms that in a given case there is no law to apply." Citizens to Preserve Overton Park v. Volpe, 401 U.S. 402, 410 (1971). *See also* Berger, *Administrative Arbitrariness and Judicial Review*, 65 COLUM. L. REV. 55, 58-83 (1965); Saferstein, *Nonreviewability: A Functional Analysis of "Committed to Agency Discretion,"* 82 HARV. L. REV. 367 (1968).

[70] *See, e.g.*, Mobil Oil Corp. v. FPC, 483 F.2d 1238 (D.C. Cir. 1973) (substantial evidence test); International Harvester Co. v. Ruckelshaus, 478 F.2d 615 (D.C. Cir. 1973) (arbitrary and capricious test); Phillips Petroleum Co. v. FPC, 475 F.2d 842 (10th Cir. 1973) (substantial evidence test).

[71] Under both standards the agency's policy choices are reviewed under the arbitrary and capricious standard which allows a court to defer to agency discretion if the policy choice is rationally related to the factual findings. SEC v. Chenery Corp., 318 U.S. 80 (1943). *See also* Friendly, *Chenery Revisited: Reflections on Reversal and Remand of Administrative Orders*, 1969 DUKE L.J. 199. The Supreme Court in Bowman Transp., Inc. v. Arkansas-Best Freight Sys., Inc., 419 U.S. 281, 284-45 (1974), approved this unsymmetrical treatment of fact and policy questions.

[72] Universal Camera Corp. v. NLRB, 340 U.S. 474, 490 (1951).

[73] *See* 4 K. DAVIS, ADMINISTRATIVE LAW TREATISE § 29.02 (1958).

record when its factual underpinning is not "provable" within the judiciary's accepted definition of "proof."[74] By contrast, the traditional arbitrary and capricious standard was limited to merely determining whether the agency possessed sufficient authority to issue the rule and whether a rational basis for the rule exists,[75] *i.e.*, whether any set of facts could be imagined to support the rule in question.[76]

2. The Appropriate APA Standard of Review for Informal Rulemaking

The District of Columbia Court of Appeals in *Automotive Parts & Accessories Ass'n v. Boyd*[77] held that, unless clearly required by the agency's organic statute, the substantial evidence test is inapplicable to informal rulemaking.[78] In this case, manufacturers of automobile accessories challenged a regulation promulgated under the National Traffic and Motor Vehicle Safety Act,[79] which required all new cars to be equipped with frontseat head restraints.[80] The manufacturers argued that the act's requirement that the agency file with the court "the record of the proceedings on which the Secretary based his order"[81] necessitated formal rulemaking. The court rejected this argument and approved section 553 procedures.[82] The "record" requirement was met by filing all information the agency had before it when it made its decision.[83] In dicta, the court stated that the substantial

[74] *See, e.g.*, International Harvester Co. v. Ruckelshaus, 478 F.2d 615 (D.C. Cir. 1973), where EPA was attempting to predict future events with no past experience on which to rely and with sketchy and speculative factual information on the available emission control technology. Similarly, in Industrial Union Dep't v. Hodgson, 499 F.2d 467 (D.C. Cir. 1974), the Department of Labor was attempting to promulgate an exposure standard based on a problematical prediction of the percentage of asbestos workers who would develop fatal cancers in two to three decades if subjected to some unknown level of exposure through a biological mechanism as yet unidentified.

[75] *See, e.g.*, United States v. George S. Bush & Co., 310 U.S. 371 (1940); Superior Oil Co. v. FPC, 322 F.2d 601 (9th Cir. 1963), *cert. denied*, 377 U.S. 922 (1964). *See* L. JAFFEE, JUDICIAL CONTROL OF ADMINISTRATIVE ACTION 564 (1965).

[76] Pacific States Box & Basket Co. v. White, 296 U.S. 176 (1935).

[77] 407 F.2d 330 (D.C. Cir. 1968).

[78] *Id.* at 337. *Accord*, Bunny Bear, Inc. v. Peterson, 473 F.2d 1002 (1st Cir. 1973); Boating Indus. Ass'n v. Boyd, 409 F.2d 408 (7th Cir. 1969).

[79] 15 U.S.C. §§ 1381-1390 (1976).

[80] Motor Vehicle Safety Standard No. 202, 33 Fed. Reg. 2945 (1968).

[81] 15 U.S.C. § 1394(a) (1976).

[82] 407 F.2d at 338.

[83] *Id.* at 337.

evidence test is applicable only to formal rulemaking and adjudication. The court in describing the appropriate standard of review under section 706(2)(A) stated: "The paramount objective [of judicial review] is to see whether the agency, given an essentially legislative task to perform, has carried it out in a manner calculated to negate the dangers of arbitrariness and irrationality in the formulation of rules for general application in the future."[84] However, the Sixth Circuit obfuscated this clear analysis by reaching the opposite conclusion in *Chrysler Corp. v. Department of Transp.*[85] The court held that the applicable scope of review under the National Traffic and Motor Vehicle Safety Act is the substantial evidence test and rejected the test set out in *Automotive Parts* as providing "virtually no review at all."[86]

The court in *City of Chicago v. FPC*[87] described the purpose of reviewing rulemaking actions as determining whether a reasoned conclusion from the whole record could support the premises upon which the agency decision rests.[88] The substantial evidence test in the court's view is an application of this analysis to a particular kind of record—one containing specific information tested by cross-examination.[89] The court in effect obliterated all distinctions between judicial review of formal and informal rulemaking except the name. This broad scope of review was based on an analysis of the nondelegation doctrine. Although rulemaking is a quasi-legislative function, it is not the equivalent of legislative action, and agency findings of fact are not accorded the same deference as legislative conclusions.[90] If an agency's findings were exempt from judicial review, the law governing delegation would be "little more than formalistic mutterings," as it would make little sense to require the legislature to articulate intelligible standards to govern agency action of an authentic inquiry into whether those standards are being complied with *vel non* is foreclosed.[91] The court concluded that inquiry into the factual predicate for adopted rules is authorized and that the

[84] *Id.*
[85] 472 F.2d 659 (6th Cir. 1972).
[86] *Id.* at 667.
[87] 458 F.2d 731 (D.C. Cir. 1971).
[88] *Id.* at 744.
[89] *Id.*
[90] *Id.* at 742.
[91] *Id.*

nature of the inquiry depends on the nature of the record on review.[92]

These cases demonstrate the lack of consensus as to the appropriate standard of review.[93] This disagreement has helped erode the traditional distinction between the respective standards of judicial review of rulemaking.[94] The merging of reviewing standards has rendered mechanical labeling of the appropriate reviewing standard a Sisyphean effort, which is often counterproductive because it obscures the mandatory flexibility of judicial review.[95] The label used to identify the type of review is not as important as the judicial philosophy underlying review.

The increased judicial vigilance[96] demonstrated in rulemaking actions and the consequent reduction in the deference accorded agency discretion[97] stems from the emergence of broad and

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[92] *Id.* at 743.

[93] The Supreme Court has further obfuscated the matter by apparently equating formal and informal rulemaking and assuming that substantial evidence is the appropriate standard for reviewing informal rulemaking. *See* United States v. Allegheny-Ludlum Steel Corp., 406 U.S. 742, 753 (1972); United States v. Midwest Video Corp., 406 U.S. 649, 671-73 (1972); Citizens to Preserve Overton Park v. Volpe, 401 U.S. 402, 414-15 (1971). However, Camp v. Pitts, 411 U.S. 138, 142 (1973), clarifies the situation by limiting judicial review of informal rulemaking to the arbitrary and capricious standard of section 706(2)(A). *See* Note, *Judicial Review of the Facts in Informal Rulemaking: A Proposed Standard*, 84 YALE L.J. 1750, 1757 (1975).

[94] *See* Associated Indus. of N.Y. State, Inc. v. United States Dep't of Labor, 487 F.2d 342 (2d Cir. 1973) ("[I]n the review of rules of general applicability made after notice and comment rulemaking, the two criteria do tend to converge." *Id.* at 349-50.). National Nutritional Foods Ass'n v. Weinberger, 512 F2d 688 (2d Cir. 1975) (Lumbard, J., concurring) (agency abuses discretion and acts arbitrarily and capriciously if its actions are not supported by substantial evidence. *Id.* at 705).

[95] *See* K. DAVIS, ADMINISTRATIVE LAW OF THE SEVENTIES § 29.01 (1976) (judges accept or reject agency rules not by applying a formula of judicial review, but by discerning the level of care used in the development of the rule); Universal Camera Corp. v. NLRB, 340 U.S. 474 (1951) (lack of certainty in the standard of judicial review reflects the impossibility of a single formula describing all factors involved in judicial review). *Cf.* City of Chicago v. FPC, 458 F.2d 731, 739 (D.C. Cir. 1971).

[96] *See* L. JAFFEY, JUDICIAL CONTROL OF ADMINISTRATIVE ACTION 589 (1965). The new judicial activism is in marked contrast to the prevalent attitude of earlier days succinctly epitomized by Chicago B & Q Ry. v. Babcock, 204 U.S. 585 (1907), wherein the Supreme Court upheld the "sensible judgments" of a board of tax assessors on the ground that they "express an intuition of experience which outruns analysis." *Id.* at 598.

[97] Prior to Universal Camera Corp. v. NLRB, 340 U.S. 474 (1951), reviewing courts, even when utilizing the substantial evidence standard, often felt constrained to uphold the agency's determination if it was supported by some evidence anywhere in the record "without reference to how heavily the countervailing evidence may preponderate." *Id.* at 481. *Universal Camera* changed this attitude by requiring that the decision be supported by the record "as a whole."

sweeping rulemaking authority. Agencies can affect individual rights and interests throughout society without any type of hearing,[98] and this broad authority evokes an apprehensive judicial reaction. The broad sweep of the statutes also promotes a heightened belief in the importance of providing participation by interested parties and careful articulation of agency methodologies and conclusions. Perhaps the emphasis on an increased opportunity for participation in the rulemaking arena is a manifestation of an analogous phenomenon in other areas. Since *Goldberg v. Kelly*,[99] there has been a torrent of due process cases in disparate areas of governmental activity in which the Supreme Court has expanded the hearing requirement.[100] However, the case which directly propagated rigorous scrutiny of administrative actions is the Supreme Court's opinion in *Citizens To Preserve Overton Park v. Volpe*.[101]

3. *Overton Park*'s Substantial Inquiry

Although dealing with judicial review of an administrator's informal decision and not informal rulemaking, the *Overton Park* decision has been repeatedly applied to rulemaking proceedings. This case dealt with the scope of the Secretary of Transportation's authority under the Federal Highway Act, which authorized expenditure of federal funds to construct highways through public parks only if no "feasible and prudent" alternative exists and if such program is designed to minimize harm to the park.[102] The Secretary concurred in the judgment of local officials that the highway should be built through the park, but did not include a statement of his factual findings in his decision. The district court and the court of appeals upheld the Secretary's determination, believing that the Secretary had broad discretion and that reviewing courts had a narrow scope of review.[103] The Supreme Court reversed, rejecting these contentions and subjecting the Secretary's decision to judicial review under the APA.[104]

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[98] *See* 5 U.S.C. § 553(c) (1976).

[99] 397 U.S. 254 (1970).

[100] *See, e.g.*, North Ga. Finishing, Inc. v. Di-Chem, Inc., 419 U.S. 601 (1975); Goss v. Lopez, 419 U.S. 565 (1975); Morrissey v. Brewer, 408 U.S. 471 (1972); Fuentes v. Shevin, 407 U.S. 67 (1972).

[101] 401 U.S. 402 (1971).

[102] 49 U.S.C. § 1653(f) (1970).

[103] 401 U.S. at 409.

[104] Petitioners were entitled to judicial review under 5 U.S.C. § 701 (1976), which

The Supreme Court went on to order the district court to conduct a plenary review of the Secretary's decision[105] based on the full administrative record that was before the Secretary when he made his decision. If the record does not disclose the determinative factors in the Secretary's construction of the evidence, the district court was empowered to require additional explanation, even to the extent of requiring administrative officials to give testimony explaining their actions.[106]

The critical portion of the decision dealt with the standard of judicial review under APA section 706. The Court held that despite the inapplicability of the substantial evidence test to the Secretary's decision, "the generally applicable standards of § 706 require the reviewing court to engage in a *substantial inquiry*."[107] After recapitulating the aphorism that the Secretary's action is entitled to a presumption of regularity, the Court declared that "that presumption is not enough to shield his action from a thorough, probing, in-depth review."[108]

Under *Overton Park*, a court has three functions to fulfill in reviewing agency action. First, it must delineate the scope of the agency's authority and discretion and then determine whether the agency acted within the scope of its authority by scrutinizing the facts.[109] Second, the court must find that the actual choice

provides that the action of "each authority of the Government of the United States" is subject to judicial review unless there is a statutory prohibition on review or where "agency action is committed to agency discretion by law." The Court held that there was "law to apply" and the "committed to agency discretion" exemption of 5 U.S.C. § 701(a)(2) was inapplicable. 401 U.S. at 410.

[105] On remand, the district court conducted a "substantial inquiry" by mandating diverse procedural safeguards. Citizens To Preserve Overton Park v. Volpe, 335 F. Supp. 873 (W.D. Tenn. 1972). The court ruled that the plaintiffs were entitled to discovery to determine whether the record was complete and to explore the mental processes of the agency personnel. *Id.* at 877. They were also entitled to adduce expert testimony to show that feasible and prudent alternative routes existed and to evaluate the Secretary's investigation of such alternative routes. *Id.* Finally, a plenary hearing was conducted which consumed 25 trial days and admitted 240 exhibits and 287 pages of posttrial briefs. *Id.* at 878.

[106] 401 U.S. at 420. Although such an inquiry into the mental processes of the decisionmakers is usually to be avoided, if there are no contemporaneous formal findings, such an inquiry may be the only effective method of judicial review. *Id. See* Nathanson, *Probing the Mind of the Administrator: Hearing Variations & Standards of Judicial Review Under the Administrative Procedure Act & Other Federal Statutes*, 75 COLUM. L. REV. 721 (1975).

[107] 401 U.S. at 415 (emphasis added). Informal rulemaking is reviewed under the same standard. 5 U.S.C. § 706(2)(A) (1976).

[108] 401 U.S. at 415.

[109] *Id.* at 415-16.

made was not "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law" in order to uphold the agency action. To make this finding the court must again scrutinize the facts to determine whether the "decision was based on a consideration of the relevant factors" and whether there has been a "clear error of judgment."[110] In both cases, the inquiry into the facts must be "searching and careful."[111] Finally, the court must determine whether the agency followed the necessary procedural requirements.[112] In essence, this three-part analysis advocates a vigilant approach to agency review in which the court does not make the ultimate decision, but insists that the agency take a hard look at all relevant factors.

4. Application of *Overton Park* to Informal Rulemaking

No firm consensus exists for the method of applying the *Overton Park* standard of review to informal rulemaking or for the proper amount of scrutiny to be used in reviewing the factual basis of agency action.[113] The opinions presented in *Ethyl Corp. v. EPA*[114] demonstrate a continuum of views on this issue by contrasting the views of the judges of the District of Columbia Court of Appeals.[115] This case involved a petition to review an EPA order under the Clean Air Act requiring an annual reduction in the lead content of gasoline.[116]

Judge Wright, writing for the majority,[117] affirmed the Administrator's decision and rejected petitioner's objection that three notice and comment periods were procedurally defective.[118] In upholding the administrative action, Judge Wright described

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[110] *Id.* at 416.

[111] *Id.*

[112] *Id.* at 417.

[113] *See generally* Note, *Judicial Review of the Facts in Informal Rulemaking: A Proposed Standard,* 84 YALE L.J. 1750 (1975).

[114] 541 F.2d 1 (D.C. Cir. 1976).

[115] The opinions of this court have special importance for administrative law because it is an optional venue under a plethora of regulatory statutes, it has exclusive jurisdiction over the actions of EPA under the Clean Air Act, 42 U.S.C. § 1857h-5 (1970 & Supp. V 1975), and it has attracted the largest share of environmental litigation. *See* Friendly, *Some Kind of Hearing,* 123 U. PA. L. REV. 1267, 1310 (1975).

[116] 42 U.S.C. § 1857f-6c(c)(1)(A) (1970).

[117] Judge Wright's majority opinion was joined in by Chief Judge Bazelon and Circuit Judges McGowan, Leventhal, and Robinson.

[118] 541 F.2d at 48.

the standard of review of informal rulemaking[119] as "a highly deferential one" which "presumes agency action to be valid," but which is not merely superfluous or a rubberstamp for the agency decision.[120] He went on to state that no inconsistency exists between a deferential standard of review and a requirement that the reviewing court involve itself in even the most complex evidentiary matters; the more technical the case, the more intensive must be the court's effort to comprehend the evidence.[121] This immersion in the evidence is designed solely to enable the court to determine whether the agency decision was rational and based on consideration of the salient factors. Judge Wright in analyzing *Overton Park* concluded that it no more than affirmed the tradition rational basis test.[122]

> [A]fter our careful study of the record, we must take a step back from the agency decision. We must look at the decision not as the chemist, biologist or statistician that we are qualified neither by training nor experience to be, but as a reviewing court exercising our narrowly defined duty of holding agencies to certain *minimal standards of rationality.*[123]

Judge Leventhal, in his concurrence, interpreted the majority opinion as advocating no substantive review at all.[124] He stated that this type of review does not fulfill the reviewing court's mandate of ensuring that the agency outlines its objectives in a rational and nondiscriminatory manner so that its delegated power is exercised only within its statutory parameters.[125] Judge Leventhal stated that when an agency is confronted with a factually based challenge, the court must examine the evidence and findings of fact to ensure that the evidentiary fact findings are supported by the record and that they provide a rational basis for inferences of ultimate fact.[126] If the agency's decision is within a zone of reasonableness, though not the one the court would have

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[119] Judge Wright assumed that informal rulemaking under 5 U.S.C. § 553 (1976) is reviewed under 5 U.S.C. § 706(2)(A) (1976), under which agency action is upset if it is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." *See* note 67 *supra*.

[120] 541 F.2d at 34.

[121] *Id.* at 34-35.

[122] *Id.* at 34-35 n.74.

[123] *Id.* at 36 (footnote omitted; emphasis added).

[124] *Id.* at 68 (Leventhal, J., concurring without reservation).

[125] *Id.* at 69.

[126] *Id.*

chosen, it must be sustained. One of the least intrusive but most effective methods of review is to have the agency comply with certain minimal procedural safeguards. These procedures will vary from problem to problem and must be fitted in an *ad hoc* fashion to the issues at hand.[127]

Judge Wilkey, in his dissenting opinion,[128] applied *Overton Park's* substantial inquiry analysis by focusing on the "clear error of judgment" language, which allows a reviewing court to overturn agency action even if there is evidence in the record supporting the agency decision.[129] After reviewing the whole record, a court may conclude that the agency erred in exercising its rulemaking power, because the evidence against the agency's conclusion is overwhelming and persuasive, the agency's approach is one-sided, the decisionmaking process is flawed, or an essential point or element is missing in the logical progression towards the agency's conclusion.[130] The court's task on review is "to explore the evidentiary record to determine whether the statements and conclusions of fact have an adequate basis in the underlying evidence" and to determine whether the agency decision is "principled and reasonable."[131] In applying this standard, the dissent concluded that the Administrator had made clear errors in his analytical and evaluative methodology and in his decisionmaking process. Several vital links in EPA's chain of reasoning were unsupported, its conclusions were thus arbitrary and capricious, and the court's proper action should have been to remand.

Judge Skelly Wright, another judge in this circuit, has stated that APA section 706 requires substantive review.[132] The arbitrary and capricious standard does not apply to the fact-finding, fact-predicting, and factual reasoning process which leads an agency to adopt a rule. A contrary interpretation of this standard would reduce judicial review to "a relatively futile exercise in formal-

[127] *See generally* Leventhal, *Environmental Decisionmaking and the Role of the Courts*, 122 U. PA. L. REV. 509 (1974).

[128] 541 F.2d at 70 (Wilkey, J., dissenting). Judge Wilkey was joined in this opinion by Circuit Judges Tamm and Robb.

[129] *Id.* at 98.

[130] *Id.*

[131] *Id.* at 100.

[132] Wright, *The Courts and the Rulemaking Process: The Limits of Judicial Review*, 59 CORNELL L. REV. 375 (1974).

ism."[133] However, Judge Wright went on to state that a reviewing court is not authorized to examine whether the agency's empirical conclusions have support in substantial evidence and emphasized that a court may not substitute its judgments for the agency's.[134]

D. *Judicial Expansion of Section 553 Requirements*

Courts have begun to explore the full reach of section 553 requirements. An expanded interpretation of this section's requirements has resulted from the confluence of constraining administrative discretion, making factual determinations in informal rulemaking proceedings, and reviewing administrative action. Courts reinterpreted section 553 requirements in order to effectuate these three principles; indeed, some courts read the statutory requirements so expansively as to be accused of creating a new type of rulemaking unconnected with the APA.[135] The original decisions mandating hybrid rulemaking procedures were premised on basic considerations of fairness,[136] because the courts did not have the crucial element of *Overton Park's* aggressive technique of judicial review and were forced to rely upon their misgivings about the extent of administrative discretion and the adequacy of notice and comment procedures to answer factual questions. After *Overton Park,* the courts gained momentum in prescribing adjudicatory procedures. This momentum was completely dissipated by the Supreme Court's decision in *Vermont Yankee Nuclear Power Corp. v. Natural Resources Defense Council, Inc.*[137] The three following subsections outline the presently existing requirements of section 553.

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[133] *Id.* at 390.

[134] *Id.* at 391.

[135] *See* FitzGerald, *Mobil Oil Corp.* v. *Federal Power Commission and the Flexibility of the Administrative Procedure Act,* 26 AD. L. REV. 287 (1974).

[136] Walter Holm & Co. v. Hardin, 449 F.2d 1009 (D.C. Cir. 1971); American Airlines, Inc. v. CAB, 359 F.2d 624 (D.C. Cir.) (en banc), *cert. denied,* 385 U.S. 843 (1966).

[137] No. 76-419 (Sup. Ct. April 3, 1978). Before explaining the present judicial interpretation of section 553, a caveat is necessary. The Supreme Court severely chastised the Court of Appeals and minced no words in its condemnation of the appellate court's interpretation of the administrative-judicial relationship. Consequently, other inroads which courts have made on the administrative process may be in jeopardy and a court may be acting *ultra vires* if it imposes any requirement in excess of the bare minimum requirements of section 553. Courts may hereafter be hesitant to broadly interpret any of the procedural requirements of section 553, but may focus more closely on the adequacy of the record. *See* slip op. at 13-14 n.14, 22.

1. Inadequate Notice

Agencies intending to promulgate rules under the auspices of section 553 must publish a general notice of proposed rulemaking in the *Federal Register*. The notice must include *inter alia*, "either the terms of substance of the proposed rule or a description of the subjects and issues involved."[138] The legislative history of the APA explains that this requirement was included because public rulemaking would be of little value either to interested parties or to the agency unless notice is promulgated in advance so that interested parties could provide input.[139]

Mobil Oil Corp. v. FPC,[140] demonstrates how agency action can be overturned for failing to comply with the notice requirement. In *Mobil Oil*, the Federal Power Commission published a notice that it was considering the adoption of a general policy statement concerning transportation rates for natural gas.[141] The notice concerned only the wisdom of establishing such a policy and comments were limited to that issue. After the agency received comments from concerned groups, meetings were held with some interested parties. At the conclusion of the meetings, further conferences were deferred, and shortly thereafter the FPC issued an order setting generally applicable rates for the transportation of hydrocarbons[142] without benefit of the requisite technical and factual data on costs ordinarily required in ratemaking.[143] The court reversed the FPC order and remanded to the Commission for further proceedings because the Commission's notice was inadequate for a proceeding fixing specific mandatory rates.[144]

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[138] 5 U.S.C. § 553(b)(3) (1976).

[139] S. Doc. No. 248, 79th Cong., 2d Sess. 18 (1946).

[140] 483 F.2d 1238 (D.C. Cir. 1973).

[141] Notice of proposed statement of general policy concerning charges for transporting liquids and liquifiable hydrocarbons. 33 Fed. Reg. 2860 (1968).

[142] Order establishing charges for transporting liquids and liquifiable hydrocarbons. 37 Fed. Reg. 2954 (1972).

[143] 483 F.2d at 1244-45.

[144] *Id.* at 1263. Another panel of the same court in American Pub. Gas Ass'n v. FPC 498 F.2d 718 (D.C. Cir. 1974), held that the FPC's use of a rulemaking format that combined written statements, public hearings to receive oral statements, and written rebuttal submission was adequate. The *Mobil* decision was distinguished on the ground that the notice had been inadequate and the FPC had relied on data obtained by informal and, to some extent, *ex parte* procedures. By contrast, the FPC in *American Public Gas* had clearly stated the issues and had given the parties an adequate opportunity to participate. *Id.* at 723.

Thus, the notice will be scrutinized on review to determine if the enacted rule is outside the scope of the proposed rulemaking notice, because one of the functions of judicial review is to determine if the agency considered all relevant comments prior to enactment of the rule.[145] If potential participants are unaware or misapprehend the scope of a proceeding, they are unable to submit comments, thus depriving the agency of their input.

The notice of proposed rulemaking must be "sufficiently descriptive of the 'subjects and issues involved' so that interested parties may offer informed criticism and comments."[146] The requirement of giving notice of the "issues involved" could be read as mandating that agencies disgorge the data and policies underlying the proposed rule.[147] Notices should contain the proposed regulation and a statement of its factual premises and methodology, including its tentative empirical findings and a description of the critical experiments and methodological techniques.[148] All significant information developed during the rulemaking must be made available to the participants prior to issuance of the final regulations. If an agency does not fully comply with these directives, its decision can be overturned for failure to observe "a procedure required by law"[149] or because objectors are denied an opportunity to participate (by probing the agency's analysis and by providing information).

The decision in *International Harvester Co. v. Ruckelshaus*[150] emphasized the importance of promulgating a complete notice which indicates the major issues to be resolved, and how notice relates to the other requirements of informal rulemaking. In this case, EPA decided not to defer for one year the effective date of the Clean Air Act's 1975 automobile emission control standards. The act provided that engines manufactured in model year 1975 should have a ninety percent reduction in the emission of carbon

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[145] *See* text accompanying notes 212-230 *infra.*

[146] Ethyl Corp. v. EPA, 541 F.2d 1, 48 (D.C. Cir. 1976) (quoting Portland Cement Ass'n v. Ruckelshaus, 486 F.2d 375, 392-94 (D.C. Cir. 1973), *cert. denied,* 417 U.S. 921 (1974) and Mobil Oil Corp. v. FPC, 483 F.2d 1238, 1251 n.39 (D.C. Cir. 1973)).

[147] *See* Wright, *Court of Appeals Review of Federal Regulatory Agency Rulemaking,* 26 AD. L. REV. 999, 204 (1974).

[148] International Harvester Co. v. Ruckleshaus, 478 F.2d 615 (D.C. Cir. 1973).

[149] 5 U.S.C. § 706(D) (1976).

[150] 478 F.2d 615 (D.C. Cir. 1973).

monoxide and hydrocarbons over 1970 model engines.[151] A one year suspension from these standards could be granted by EPA if it determined after a "public hearing" that the technology to meet the 1975 standards was not available.[152] As EPA based its determination on a complex "prediction methodology" never revealed to the automobile companies, the court remanded the case to EPA for further consideration and imposed upon the agency the requirement of providing "the parties . . . [an] opportunity . . . to address themselves to matters not previously put before them."[153]

The remand was premised on the court's perception that the notice requirement of APA section 553 was not adequately complied with, because the prediction methodology should have been published prior to EPA's final decision.[154] As the automobile industry raised serious questions about EPA's methodology, it should have been provided with an opportunity to challenge the critical steps of EPA's reasoning process. The auto companies had put forth all of their available data, but EPA merely rebutted it with their prediction methodology without any supporting data. If this were allowed to be sufficient, the information adduced by the auto companies would be effectively meaningless, and they would be effectively precluded from challenging EPA's data.

In *Portland Cement Ass'n v. Ruckelshaus,*[155] EPA's regulations were rejected because the petitioner was unable to obtain critical information which formed a partial basis for the final regulations.[156] The petitioners were, thus, effectively denied an adequate opportunity to comment on the proposed standards because of EPA's failure to disclose the detailed findings and

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[151] 42 U.S.C. § 1857f-1(b)(1)(A) (Supp. V 1975).

[152] 42 U.S.C. § 1857f-1(b)(5)(D) (Supp. V 1975).

[153] 478 F.2d at 649.

[154] The necessities of judicial review also provided impetus for the court's expansive reading of the notice requirement. Neither the majority opinion by Judge Leventhal nor the concurrence by Chief Judge Bazelon attempted to describe the standard of review in traditional APA terms, *i.e.*, arbitrary or capricious or substantial evidence. However, both judges agreed that the function of judicial review is to require reasoned decisionmaking to assure that the agency procedures provide a structure for agency decisionmaking, and both evinced a growing dissatisfaction with the traditional rational basis standard. 478 F.2d at 649.

[155] 486 F.2d 375 (D.C. Cir. 1973), *cert. denied,* 417 U.S. 921 (1974).

[156] *Id.* at 392-93.

procedures of relevant EPA-sponsored tests.[157] In referring to section 553 requirements the court states, "Obviously a prerequisite to the ability to make meaningful comment is to know the basis upon which the rule is proposed."[158] The court stated that information forming the basis of a rule should be disclosed as early as possible, generally at the time of issuance.[159]

2. Failure to Provide an Opportunity to Participate

Section 553(c) provides that after notice the agency must give "interested persons *an opportunity to participate* in the rule making through submission of written data, views, or arguments with or without opportunity for oral presentation."[160] Hybrid rulemaking was partially premised on and can be partially explained by this statutory requirement.

a. *The rationale of hybrid rulemaking*

Courts which mandated hybrid procedures refused to apply the *expressio unius est exclusio alterius* principle of statutory construction to section 553(c) procedural safeguards. On the contrary, they attempted to expand this requirement beyond recognition. The adjudicatory procedures imposed by some courts were designed to facilitate judicial review and to assure meaningful participation with consequent reasoned decisionmaking and analysis by the agency.[161]

The court in *Natural Resources Defense Council, Inc. v. NRC*[162] stated that participation under this section must be meaningful: "[W]e would expect that [the NRC] will endeavor to *allow meaningful participation* by the public interest groups whose limited resources often relegate them to the role of contesting the studies and conclusions of industry participants."[163] Par-

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[157] *Id.* at 402.

[158] *Id.* at 393 n.67.

[159] *Id.* at 394.

[160] 5 U.S.C. § 553(c) (1976) (emphasis added).

[161] S. Doc. No. 248, 79th Cong., 2d Sess. 19-20 (1946). Some of the hybrid rulemaking cases partially relied on the legislative history which explains that because an agency is not a representative entity, "public participation . . . in the rulemaking process is essential to inform [the agency] and to afford safeguards to private interests." *Id.*

[162] 539 F.2d 824 (2d Cir. 1976), *vacated and remanded to determine mootness*, 434 U.S. 1030 (1978). This decision was vacated as moot in light of NRC's termination of GESMO (Generic Environmental Statement Mixed Oxide Fuel). 42 Fed. Reg. 65,334 (1977).

[163] 539 F.2d at 839 (emphasis added). *Accord*, Portland Cement Ass'n v. Ruckelshaus,

tially based on such a premise, courts determined what procedures would allow participation to be meaningful and required the "hybrid modes of procedure most appropriate to the issues and circumstances."[164] Judge Wikley in *Mobil Oil Corp. v. FPC*[165] reasoned that if a court knows the degree of evidentiary support required to establish a factual predicate, the court would know the type of rulemaking procedures which must be designed to create this support and which would be required to uphold the agency's decision.[166] The required procedure is not contingent upon the classification of the activity, but depends on the importance of the issues before the agency and the kinds of questions involved.[167] Complex questions should be "resolved in the crucible of debate through the clash of informed but opposing scientific and technological viewpoints."[168] However, neither a formal hearing nor cross-examination is required if an adequate opportunity to participate in developing the relevant evidence in an "adversary setting" exists.[169] The court in *Walter Holm & Co. v. Hardin,*[170] stated that an opportunity to present an effective presentation is essential to ensure that the agency will take a hard look at the problems in light of the written submissions.[171] Judge Leventhal, summarizing what adjudicatory procedures are required, stated: "What counts is the reality *of an opportunity to submit an effective presentation,* to assure that the Secretary and his assistant will take a hard look at the problems in light of those submissions."[172]

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486 F.2d 375, 393 n.67 (D.C. Cir. 1973); International Harvester Co. v. Ruckelshaus, 478 F.2d 615, 631 (D.C. Cir. 1973).

[164] Appalachian Power Co. v. EPA, 477 F.2d 495, 500 (4th Cir. 1973).

[165] 483 F.2d 1238 (D.C. Cir. 1973).

[166] *Id.* at 1257.

[167] Appalachian Power Co. v. *EPA,* 477 F.2d 495, 500-01 (4th Cir. 1973). *Cf.* Walter Holm & Co. v. Hardin, 449 F.2d 1009 (D.C. Cir. 1971); American Airlines, Inc. v. CAB, 359 F.2d 624 (D.C. Cir.), *cert. denied,* 385 U.S. 843 (1966).

[168] Ethyl Corp. v. EPA, 541 F.2d 1, 54 (D.C. Cir. 1976).

[169] American Pub. Gas Ass'n v. FPC, 498 F.2d 718, 722-23 (D.C. Cir. 1974).

[170] 449 F.2d 1009 (D.C. Cir. 1971).

[171] *Id.* at 1016. The court here was also concerned that the Secretary of Agriculture was abusing his discretion by circumventing the statutorily imposed hearing procedure under section 8c of the Agricultural Marketing Agreement Act of 1937, 7 U.S.C. § 608c (1976). As a means of limiting this discretion, the court of appeals directed the district court to issue a declaratory judgment that petitioners were entitled to a hearing with a limited right of cross-examination on "crucial" issues. *Id.* The court stated that where petitioners made "a not insubstantial claim that an effective showing requires oral presentation to Department officials . . . this right is available to them." *Id.*

[172] Walter Holm & Co. v. Hardin, 449 F.2d 1009, 1016 (D.C. Cir. 1971).

The court in *Mobil Oil Corp. v. FPC*[173] explained its rationale[174] for imposing hybrid procedures by stating that the APA is not dichotomized into two mutually exclusive procedures; rather, it outlines a continuum of available hybrid procedures located between the minimum and maximum articulated in section 553 and sections 556 and 557, respectively.[175] Flexibility in fitting administrative procedures to particular functions was declared to be the touchstone in evaluating the APA.[176] This flexible attitude towards procedure is designed to assist eclectic agencies in meeting the multifarious situations arising as a result of their diverse statutory authorization. However, the court failed to recognize an unwanted ramification of this analysis, viz., administrative agencies would be placed in the quandry of choosing in advance the appropriate procedure from a limitless variety of permutations within the APA's boundaries. Once the putative dichotomy under the APA is abandoned, the type of procedures in a rulemaking proceeding becomes a litigable issue. The agency could be certain that it utilized the proper procedural devices only in an ex post facto fashion after the rendering of an appellate opinion. A similar analysis prompted the Supreme Court in *Vermont Yankee Nuclear Power Corp. v. Natural Resources Defense Council, Inc.*[177] to negate any further judicial imposition of adjudicatory procedures.

b. Vermont Yankee

The Vermont Yankee Nuclear Power Corporation applied for a license to operate its nuclear plant, and, upon NRDC's objection to the granting of the license, a hearing was held on the

[173] 483 F.2d 1238 (D.C. Cir. 1973).

[174] Another potential rationale was that the section 553(c) requirement of giving interested persons an opportunity to participate "with or without opportunity for oral presentation," grants the agency discretion to decide whether such an opportunity will be granted; but since a court is authorized to set aside agency action found to be "an abuse of discretion," denial of such a request can be held to be reversible error. *See* Chemical Leaman Tank Lines, Inc. v. United States, 368 F. Supp. 925, 946 (D. Del. 1973). Thus, whenever a rulemaking proceeding involves a contested factual issue which is crucial in determining the reasonableness of the rule and which is readily susceptible to the taking of evidence, an agency may abuse its discretion if it fails to conduct an evidentiary hearing. *See* Claggett, *Informal Action—Adjudication—Rulemaking: Some Recent Developments in Federal Administrative Law*, 1971 DUKE L.J. 51, 78, 86.

[175] 483 F.2d at 1251.

[176] *Id.*

[177] No. 76-419 (Sup. Ct. April 3, 1978).

application.[178] The licensing board excluded testimony involving the environmental effects of operations to reprocess and dispose of nuclear fuel as not required under NEPA and granted the operating license. Subsequently, a generic rulemaking was initiated by the Commission to specifically deal with the question of these environmental effects. Although discovery and cross-examination were not allowed, extensive background documents were publicly available, all participants were granted a reasonable opportunity to present their positions, written and oral statements were received, and all persons giving oral statements were subject to cross-examination by the hearing board.[179] After the hearing was completed, the Commission approved the rulemaking procedures, adopted a rule based on the data collected, and declared that, because the environmental effects are "insignificant," the NEPA benefit-cost analysis would not be affected and the granting of Vermont Yankee's operating license would not have to be reexamined.[180] The District of Columbia Court of Appeals reversed and remanded the portion of the order which adopted a regulation concerning nuclear waste, held that these environmental effects had to be analyzed in each licensing proceeding, and, consequently, reversed the grant of Vermont Yankee's license.[181]

After reading the lower court as invalidating the regulation because of the inadequacy of the procedures employed, the Supreme Court reversed. The Court held that in the absence of constitutional constraints or extremely compelling circumstances, "the administrative agencies 'should be free to fashion their own rules of procedure and to pursue methods of inquiry capable of permitting them to discharge their multitudinous duties.' "[182] The Court left no doubt but that the agencies, not the courts, determine what extra procedural devices should be employed.[183]

[178] Consumers Power Co. v. Aeschliman et al., No. 76-528 (1978) (concerning review of the Commission's procedures in a formal adjudicatory proceeding).

[179] No. 76-419, slip op. at 6-7 (Sup. Ct. April 3, 1978).

[180] *Id.* at 8. The Commission also vacated the Appeal Board decision in *Vermont Yankee* insofar as it differed from the rule as adopted. The Commission decided to require licensing boards to consider the environmental effects as they are enumerated in Table S-3, 10 C.F.R. 51.20(e) (1977).

[181] Natural Resources Defense Council, Inc. v. NRC, 547 F.2d at 641, 655.

[182] *Id.* at 21 (citing FCC v. Schreiber, 381 U.S. 279, 290 (1965), quoting from FCC v. Pottsville Broadcasting Co., 309 U.S. 134, 143 (1940)).

[183] No. 76-419, slip op. at 24 (Sup. Ct. April 3, 1978).

The Court held that a court cannot review and overturn a rule-making proceeding on the basis of what procedural devices were employed, so long as the agency employs at least the APA minimums.[184] The Court went on to explain that the proper scope of judicial review of agency action comprehends a determination of the adequacy of the record.[185] If the record is deemed inadequate, it will be remanded, and the agency will be allowed to "exercise its administrative discretion in deciding how, in light of internal organization considerations, it may best proceed to develop the

[184] *Id.* at 26. In order to evaluate the effect of the Court's opinion, the cases relied on by it must be analyzed. The Supreme Court was interpreting the requirements of the APA, but none of the holdings relied on by the Court [for the proposition that the APA does not authorize courts to prescrive prescribe procedures] are on point. FPC v. Transcontinental Gas Pipeline Corp., 423 U.S. 326 (1976), dealt with a court of appeals order which directed the FPC how to investigate a claim and which deferred its review of the Commission's order pending the investigation. This case was based on an interpretation of section 19(b) of the Natural Gas Act, 15 U.S.C. § 717r(b) (1970), which stated that the Commission must have the opportunity to review its order based on the evidence it obtained after remand. The appellate court's method directly contravened the statutory procedure.

Similarly, FCC v. Schreiber, 381 U.S. 279 (1964), involved an interpretation of section 4(j) of the Communications Act of 1934, 47 U.S.C. § 154(j) (1958), which expressly grants the FCC broad discretion in how to conduct its proceedings to grant licenses. In this case, the appellate court totally usurped the Commission's function in direct contravention of the act by not only prescribing the procedures to be used, but by also making the initial decision on the evidence collected after remand. 381 U.S. at 333. FCC v. Pottsville Broadcasting Co., 309 U.S. 134 (1939), also involved an interpretation of the Communications Act and the respective roles played by the FCC and the courts under it.

Civil Aeronautics Board v. Herman, 353 U.S. 322 (1956), involved an interpretation of section 1004(b) of the Civil Aeronautics Act of 1938, ch. 601, 52 Stat. 102 1021, *as amended,* 49 U.S.C. § 644(b) (1970). The Court in Oklahoma Press Pub. Co. v. Walling, 327 U.S. 186 (1945) held that section 9 of the Federal Trade Comm'n Act, ch. 311, 38 Stat. 717 (1914) (current version at 15 U.S.C. §§ 41-51 (1970)), contained no provision for judicial review of the applicability of the act to the subject company prior to judicial enforcement of a subpoena duces tecum. Wallace Corp. v. NLRB, 323 U.S. 248 (1944), involved judicial acceptance of procedures devised by the Labor Board, not the imposition of procedures by a court. Endicott Johnson Corp. v. Perkins, 317 U.S. 501 (1943), construed the Walsh-Healy Act, ch. 881, 49 Stat. 2036 (1936) (current version at 41 U.S.C. §§ 35-45 (1970)), as precluding district court review of whether the act applies to the subject company when the agency authorized to administer the act applies for a subpoena duces tecum. Utah Fuel Co. v. National Bituminous Coal Comm'n, 306 U.S. 56 (1939), involved a construction of section 10(a) of the Bituminous Coal Act, ch. 127, 50 Stat. 72 (1937) (version at 15 U.S.C. § 838 (1937) eliminated), and whether a petition for an injunction stated a cause of action. Finally, Norwegian Nitrogen Co. v. United States, 288 U.S. 294 (1933), construed section 315 of the Tariff Act, ch. 356, 42 Stat. 941 (1922) (current version in scattered sections of 19,31,46 U.S.C.), which gave the Tariff Commission board authority "to adopt such reasonable procedures, rules, and regulations as it may deem necessary." Additionally, almost all of these cases preceded the APA so that they could in no way be deemed authority for a construction of it.

[185] No. 76-419, slip op. at 22 (Sup. Ct. April 3, 1978).

needed evidence and how its prior decision should be modified in light of such evidence as develops."[186] Because the Court was not certain whether the proceedings had provided a sufficient basis upon which to predicate the rule, the decision was remanded to the Court of Appeals for further review.

The Court also recognized that in exceptional circumstances, "when an agency is making a 'quasi-judicial' determination by which a very small number of persons are exceptionally affected, in each case upon individual grounds," additional procedures may be required.[187] However, this is the type of exception which would be rarely utilized in the nuclear regulatory context, because these proceedings have at least an indirect effect on many people.

3. Failure to Clarify Basis for Administrative Decision

Section 553(c) directs agencies "[a]fter consideration of the relevant matter presented" to "incorporate in the rules adopted a concise general statement of their basis and purpose." These statements must be more than mere boilerplate.[188] They should serve as detailed, substantive support for the rule by outlining crucial empirical and policy issues, pointing to support in the record for the agency decision, and responding to all significant objections to the agency's approach and methodology submitted by the participants.[189] The agency should explain its actions by articulating with reasonable clarity its reasons for decision and by identifying the significance of crucial facts.[190] If the agency does not comply with this directive, a court may refuse to approve the rule as adopted and may remand to the agency to obviate any frustration of judicial review and to ensure that the agency gave reasoned considerations to all material facts and issues.[191] This is

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[186] *Id.*

[187] *Id.* at 20. The Court failed to address how a lack of procedures would violate the APA in this context.

[188] *See* Automotive Parts & Accessories Ass'n v. Boyd, 407 F.2d 330, 338 (D.C. Cir. 1968), where the court warned against reading the adjectives "concise" and "general" too literally.

[189] *See, e.g.*, Pillai v. CAB, 485 F.2d 1018 (D.C. Cir. 1973); National Air Carrier Ass'n v. CAB, 436 F.2d 185, 198-99 (D.C. Cir. 1970).

[190] Greater Boston Tel. Corp. v. FCC, 444 F.2d 841, 851 (D.C. Cir. 1970), *cert. denied*, 403 U.S. 923 (1971).

[191] Permian Basin Area Rate Cases, 390 U.S. 747, 792 (1968); Scenic Hudson Preservation Conference v. FPC, 354 F.2d 608 (2d Cir. 1965), *cert. denied*, 384 U.S. 941 (1966).

also necessary to ensure that participants are not deprived of the means to file an intelligent petition for reconsideration,[192] and that the agency retains an early opportunity to be appraised of and to correct any errors it may have committed.[193]

This requirement codifies a long line of decisions requiring agencies which issue reviewable orders to sufficiently explain their actions so that judicial review is feasible.[194] If no such requirement existed, regulations would be affirmed whenever a reviewing court could derive any reasonable rationale for their adoption.[195] Elucidation of the reasons and policies underlying an agency decision assists the judiciary in fulfilling its function of ensuring that agency action is the result of fair and reasoned decision-making.[196] A court is able to determine whether the agency gave the required consideration only if the agency articulates the basis of its decision and identifies the facts which it considered significant.[197] This aspect of the supervisory function requires more active interference with an agency if the court suspects that the agency has not taken a "hard look" at the salient problems and has not genuinely engaged in reasoned decision-making.[198] In the words of Judge Leventhal this process "combines judicial supervision with a salutory principle of judicial restraint, an awareness that agencies and courts together constitute a 'partnership' in furtherance of the public interest, and are 'collaborative instrumentalities of justice.' "[199]

The decision in *Environmental Defense Fund, Inc. v. Ruckelshaus*[200] demonstrates that agency action unaccompanied

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[192] 5 U.S.C. § 553(e) (1976) states "Each agency shall give an interested person the right to petition for the . . . repeal of a rule."

[193] Tabor v. Joint Bd. for Enrollment of Actuaries, 566 F.2d 705, 711 (D.C. Cir. 1977).

[194] *See, e.g.*, SEC v. Chenery Corp., 318 U.S. 80 (1943); American Broadcasting Co. v. FCC, 179 F.2d 437 Cir. 1949); Saginaw Broadcasting Co. v. FCC, 96 F.2d 554 (D.C. Cir. 1938).

[195] Tabor v. Joint Bd. for Enrollment of Actuaries, 566 F.2d 705, 710 (D.C. Cir. 1977).

[196] In view of this limited purpose, statements of less than ideal clarity have been held to be sufficient. *See* New York Freight Forwarders and Brokers Ass'n v. Federal Maritime Comm'n, 337 F.2d 289 (2d Cir. 1964), *cert. denied*, 380 U.S. 190 (1965).

[197] SEC v. Chenery Corp., 381 U.S. 80 (1943); City of Chicago v. FPC, 385 F.2d 629 (D.C. Cir. 1967), *cert. denied*, 390 U.S. 945 (1968).

[198] Pikes Peak Broadcasting Co. v. FCC, 422 F.2d 671 (D.C. Cir. 1969), *cert. denied*, 395 U.S. 979 (1969); WAIT Radio v. FCC, 418 F.2d 1153 (D.C. Cir. 1969).

[199] Greater Boston Tel. Corp. v. FCC, 444 F.2d 842, 851-52 (D.C. Cir. 1970), *cert. denied*, 403 U.S. 923 (1971).

[200] 439 F.2d 584 (D.C. Cir. 1971).

by an adequate explanation is not acceptable. In this case, the Secretary of Agriculture refused to suspend the federal registration for a pesticide under the Federal Insecticide, Fungicide, and Rodenticide Act.[201] Although the Secretary recognized a substantial question concerning the safety of DDT, he concluded that a summary suspension of its registration as interim relief during the administrative process was not warranted. This conclusion reflected both a factual determination and the application of a legal standard. The Secretary was required to first determine what harm may result and, based on his determination of the magnitude and probability of the anticipated harm, he must then decide whether this amounts to an "imminent hazard to the public."[202] The court of appeals remanded because the Secretary had not given "an adequate explanation for his decision to deny interim relief."[203] The Secretary should have determined whether the available information called for suspension by identifying the relevant factors and by relating the evidence to those factors in a statement of reasons.[204]

The Secretary has an obligation to limit the extent of his discretion by formulating suspension standards either by promulgating regulations or by articulating his criteria in each individual decision.[205] The reviewing court cannot assume that proper standards are implicit in every exercise of administrative discretion.[206] Chief Judge Bazelon in this decision made no attempt to designate the scope of review in traditional APA terms, but focused on the importance of providing a structure for the exercise of administrative discretion.[207] If a "framework for principled decisionmaking" is provided, the importance of judicial review will be diminished by the concomitant enhancement of the administrative process and the improvement in the quality of judicial review where judicial review is sought.[208] Judicial review can correct only the most flagrant abuses so it must operate to ensure

[201] 7 U.S.C. §§ 135-135k (1970). The statutory scheme is summarized in Environmental Defense Fund, Inc. v. Hardin, 428 F.2d 1093, 1095 nn.2-4 (D.C. Cir. 1970).

[202] 7 U.S.C. § 135b(c) (1970).

[203] 439 F.2d at 596.

[204] *Id.*

[205] *Id.*

[206] *Id.*

[207] *Id.* at 597.

[208] *Id.* at 598.

that the administrative process itself will confine and control the exercise of discretion.[209]

The court in *International Harvester Co. v. Ruckleshaus*[210] used a burden of proof analysis to reach a similar conclusion. After the automobile manufacturers established their argument for the infeasibility of the emission standards, EPA was required to sustain the "burden of adducing a reasoned presentation supporting the reliability of methodology."[211] The court remanded the case because the Administrator had failed to make such a presentation. The court thus used a burden-of-going-forward rationale as a device for controlling the risk of error. Although the court was hesitant to interfere with EPA's resolution of a scientific issue, it refused to defer blindly to whatever methodology EPA chose to support its analysis.

In *Kennecott Copper Corp. v. EPA,*[212] the court determined that the minimal requirements of section 553 were sufficient for the promulgation of national secondary ambient air quality standards under the Clean Air Act.[213] However, because EPA failed to disclose the basis of its action, the record was remanded for the Administrator to supply an implementing statement explaining his basis for the standard to aid the court's reviewing function.[214] Although the minimal requirement of incorporation of a statement of basis and purpose was complied with, the requirements of judicial review and "fairness" required additional exposition.[215] The court stated that, inherent in its reviewing responsibility is a requirement that it be given sufficient indication of the basis of the administrator's decision to enable it to consider whether the decision embodies an abuse of discretion or an error of law.[216]

Although the APA does not expressly require that agencies respond to the multifarious contentions addressed in the written comments, the necessity of providing a statement of basis and purpose has been construed to include the requirement of re-

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[209] *Id.*
[210] 478 F.2d 615 (D.C. Cir. 1973).
[211] *Id.* at 643.
[212] 462 F.2d 846 (D.C. Cir. 1972).
[213] 42 U.S.C. §§ 1857c-3, 4 (1970).
[214] 462 F.2d at 850.
[215] *Id.*
[216] *Id.* at 849.

sponding to significant adverse comments which offer specific contentions rebutting the factual foundations of the rule.[217] The court in *Rodway v. United States Department of Agriculture*[218] held that the statement of basis and purpose is designed to require the agency to prepare a reasoned response to the comments received, to explain how the agency resolved any significant problems raised by the comments, and to show how that resolution culminated in the ultimate rule adopted.[219] This statement is "inextricably intertwined with the receipt of comments."[220] If a party can demonstrate that a rule was promulgated without consideration of the submitted comments, the courts will reverse the agency's action as arbitrary and capricious.[221] However, the agency can limit the extent of its response to preserve the efficiency of the rulemaking process.[222]

The proposed rule's opponent's primary method for exposing weakness or error in the agency's premises and methodology is the comments he submits. If an agency is permitted to ignore them or to denigrate their importance by providing a cursory review and no response, the agency is rendering the opponent's participation meaningless. Agencies must closely evaluate these comments to be able to prepare a response. If no response is forthcoming, the reviewing court cannot determine whether the agency took the requisite hard look, whether the decision was based on

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[217] Mobil Oil Corp. v. FPC, 483 F.2d 1238 (D.C. Cir. 1973). *See* Kennecott Copper Corp. v. EPA, 462 F.2d 846, 850 (D.C. Cir. 1972).

[218] Rodway v. United States Dept. of Agriculture, 514 F.2d 809 (D.C. Cir. 1975).

[219] *Id.* at 817; *See* Greater Boston Television Corp. v. FCC 444 F.2d 841 (D.C. Cir. 1970); *cert. denied,* 403 U.S. 923 (1971).

[220] Rodway v. United States Dept. of Agriculture, 514 F.2d 809, (D.C. Cir. 1975). In support of this statement the court reasoned:

> The APA requires the reviewing court to "review the whole record" in measuring the validity of agency action. 5 U.S.C. § 706 (1970). The whole record in an informal rule-making case is comprised of comments received, hearings held, if any, and the basis and purpose statement. In this case, there is plainly no whole record to review and the District Court could not perform its appellate function. (Footnote omitted.)

Id. at 817.

[221] *See* Consumers Union of United States, Inc. v. Consumer Prod. Safety Comm'n, 491 F.2d 810, 812 (2d Cir. 1974).

[222] *See* Owensboro On the Air, Inc. v. United States, 262 F.2d 702, 708 (D.C. Cir. 1958), where the court stated "Surely every time the [FCC] decided to take account of some additional factor it was not required to start the proceedings all over again. If such were the rule the proceeding might never be terminated." *Accord,* International Harvester Co. v. Ruckelshaus, 478 F.2d 615, 632 n.51 (D.C. Cir. 1973).

a consideration of the relevant factors, or whether the agency committed a clear error of judgment.[223] When an agency decision is remanded because of failure to respond to significant comments, the remand is in aid of the judicial review function, rather than a determination that the agency order was invalid because of inadequate procedures.[224]

Cement manufacturers sought review of EPA's promulgation of stationary source standards for new or modified Portland cement plants pursuant to the Clean Air Act in *Portland Cement Ass'n v. Ruckleshaus*.[225] The court remanded because EPA failed to respond to significant adverse comments concerning legitimate problems with EPA's test methodology.[226] Agencies must demonstrate that they have given serious consideration to the submitted comments and a reviewing court may demand reasoned explanations for controversial empirical and normative agency determinations. The agency has substantial latitude over the format of the statement, but it must refer to relevant submissions by participants and should rebut or accept these submissions in an orderly fashion. The agency's duty to rationalize its decision is not met by post hoc rationalizations offered for the first time

[223] *Cf.* Citizens to Preserve Overton Park v. Volpe, 401 U.S. 402 (1971).

[224] The Supreme Court in Camp v. Pitts, 411 U.S. 138 (1973) (per curiam), outlined the proper procedure to be followed when a reviewing court decides that an administrative agency's stated justification for informal agency adjudication does not provide an adequate basis for judicial review. Although this case dealt with informal adjudication, the Court did not focus on the rulemaking-adjudication distinction, but rather on the appropriate method for reviewing informal agency action. *See* Tabor v. Joint Bd. For Enrollment of Actuaries, 566 F.2d 705, 710 (D.C. Cir. 1977). The appropriate standard of review was whether the Comptroller's decision was the "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law" as specified by APA section 706(2)(A). If the failure to explain the administrative action frustrates review, the remedy is to remand to the agency for it to provide "either through affidavits or testimony, such additional explanation of the reasons for the agency decision as may prove necessary." 411 U.S. at 143.

The court in Tabor v. Joint Bd. for Enrollment of Actuaries, 566 F.2d 705 (D.C. Cir. 1977), described the procedure to be utilized when an agency involved in informal rulemaking does not incorporate a statement of basis and purpose in the adopted rules. The proper method is to vacate the rules and remand to the agency to enable it to adopt regulations accompanied by a sufficient statement. *Id.* at 711. *Accord,* Rodway v. United States Dep't of Agriculture, 514 F.2d 809 (D.C. Cir. 1975). *But cf.* National Food Ass'n v. Weinberger, 512 F.2d 688 (2d Cir. 1975) (wherein the court did not vacate the rules and remand, but allowed the agency to present the necessary statement through affidavits or testimony before the court. *Id.* at 701.)

[225] 486 F.2d 375 (D.C. Cir. 1973).

[226] *Id.* at 393.

during judicial review of the agency action.[227] Unless an adequate agency response is prepared, the court cannot determine whether the agency took the requisite "hard look" at the problem involved.

Although written comments were submitted as required,[228] this was not sufficient to develop an adequate record and fulfill the reviewing court's duty to consider whether "the decision was based on a consideration of the relevant factors and whether there had been a clear error of judgment."[229] If the record contains only ambiguous and conclusory statements about the basis of the rule, and if a participant offers precise factual contentions rebutting the factual foundation of the rule, the rule cannot be judicially approved until factual clarification is achieved.[230] If the record fosters doubt about a necessary factual predicate of an otherwise valid rule, the court is unable to affirm the rule.

Although imposing procedural requirements in excess of the APA's minimums is no longer a viable option for courts to use when reviewing informal rulemaking, it is clear that courts are no longer bowing to bland assertions of administrative discretion. Courts must still review the adequacy of the record, and agencies must recognize that broadened participation facilitates the development of an adequate record. The holdings of many hybrid rulemaking cases would not be greatly modified if the court was precluded from imposing procedures—the record would continue to be inadequate. As Judge Friendly pointed out,[231] it is ultimately of little consequence to the agency if a court invalidates the rule because the record is inadequate or if the court goes a step further and imposes *ad hoc* procedures to generate an adequate record. In both cases, the rule is invalidated and further procedures are necessary. Now that the later procedure is unavailable, the agency must devise procedures designed to rectify the record with no judicial assistance.

Increased judicial activity has encouraged agencies to modify their rulemaking procedures and decisionmaking processes, espe-

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[227] Burlington Truck Lines, Inc. v. United States, 371 U.S. 156, 167-69 (1962).

[228] 486 F.2d at 393 n.67.

[229] *Id.* at 403 (quoting Citizens to Preserve Overton Park v. Volpe, 401 U.S. 402, 416 (1971)).

[230] 486 F.2d at 393-94.

[231] Friendly, *Some Kind of Hearing*, 123 U. PA. L. REV. 1267, 1314 (1975).

cially for rules which involve highly complex technical or scientific subject matters. Thus, if the nuclear power industry is to use rulemaking as a reform technique and as a means of self-help, it must request those procedures which are tailored to the subject matter of their proposed rule. Pure notice and comment rulemaking for important factual matters in the highly visible environmental arena, curtailed by the hybrid rulemaking cases, may not be completely revitalized, as *Vermont Yankee* merely placed the onus on each agency to determine how to devise procedures which will generate a proper record.

III. RULEMAKING AS A REFORM TECHNIQUE

In the absence of legislative reform designed to make licensing more efficient, rulemaking presents an opportunity for self-help reform. To be effective, the nuclear power industry must be willing to play the rulemaking game by proposing, rather than resisting, the appropriate degree of discovery and cross-examination in NRC rulemaking proceedings. Discovery may be used to significantly delay the proceeding, but it serves the valid purpose of providing parties with enough information to adequately advocate their interests.[232] Cross-examination contains the greatest potential for delay and it is also the most difficult device for the hearing board to control, yet it may be useful for developing an accurate and comprehensive record when complex factual issues are involved.

Prior to proposing a rule, industry proponents should select the most suitable procedural devices by considering the issues involved and the experience and capacity of the agency. One of the least intrusive, but most effective devices, is the use of interrogatories among the participants and the agency. This approach was utilized in both the GESMO[233] and the uranium fuel cycle rulemakings.[234] In both of these proceedings, written questions were more efficacious than oral ones. Unfortunately, reliance on written interrogatories is timeconsuming, the answers to technical questions are often labored and drafted by nontechnical counsel, and this device ordinarily requires followup questions to be

[232] Note, *The Use of Generic Rulemaking To Resolve Environmental Issues in Nuclear Power Plant Licensing,* 61 VA. L. REV. 869, 897 (1975).

[233] 39 Fed. Reg. 43,101 (1974).

[234] Prehearing Conference Order, Docket No. 50-3 (August 12, 1977).

effective.[235] If a second round of followup questions is required, they can be propounded at a legislative-type hearing, as occurred in the second phase of the uranium fuel cycle proceeding.[236] When there are many participants involved, the most efficient procedure is to have oral questions propounded by the hearing board.

The most intrusive procedural device, cross-examination, is extremely time consuming and should be infrequently requested. Commentators have disagreed over the effectiveness of cross-examination to resolve scientific controversies.[237] Professor Robinson has argued that cross-examination requires "the agency to explain and articulate the assumptions and the foundations on which its policies rest,[238] but he has not demonstrated that less intrusive methods would not be equally efficacious. Conversely, other commentators have stated that cross-examination frequently achieves little that could not be obtained by other devices.[239] The utility of cross-examination cannot be generalized because its utility is situation-specific, *i.e.*, it may be effective in some situations, but may be time consuming and ineffective in others.

This device may also give leverage to opponents of a proposed rule. It presents an opportunity for delay; it gives challengers a bargaining tool; and it subtly exerts pressure on the proponent to take a milder stand, so that the heavy investment of resources involved in supporting the more extreme position in

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[235] In the long run, reliance on interrogatories is much more efficient than relying on an oral hearing to obtain the information. *Compare In Re Acceptance Criteria for Emergency Core Cooling, Systems for Light Water Cooled Nuclear Power Reactors*, AEC Docket RM-50-1 (37 Fed. Reg. 288 (1972) (adjudicatory procedures adopted after initial notice of proposed rulemaking)), *with In Re Environmental Effects of the Uranium Fuel Cycle*, NRC Docket No. 50-3 (37 Fed. Reg. 24, 191 (1972) (notice of proposed rulemaking; procedures will not include cross-examination or discovery)).

[236] Prehearing Conference Order, Docket No. 50-3 (August 12, 1977).

[237] *Compare* Johnston, *AEC Rulemaking and Public Participation*, 62 GEO. L.J. 1737, 1743 (1974); (cross-examination is effective as it reveals value judgments underlying "objective" conclusions), *with* Boyer, *Alternatives to Administrative Trial-Type Hearings for Resolving Complex Scientific, Economic, and Social Issues*, 71 MICH. L. REV. 111, 129 (1972) (cross-examination may hamper rather than advance accurate factual resolution of complex scientific issues).

[238] Robinson, *The Making of Administrative Policy: Another Look at Rulemaking and Adjudication and Administrative Procedure Reform*, 118 U. PA. L. REV. 485, 522 (1970).

[239] *See, e.g.*, Williams, *"Hybrid Rulemaking" Under the Administrative Procedure Act: A Legal and Empirical Analysis*, 42 U. CHI. L. REV. 401, 430-45 (1975).

cross-examination is not required.[240] However, cross-examination may also have the beneficial effect of discouraging participation by persons who oppose a rule on general grounds, but who possess no helpful expertise, because they too will have to invest substantial resources if they desire to testify in the proceeding. Cross-examination may also play a crucial role in elucidating issues in some rulemaking contexts. Additionally, the very existence of a right to cross-examination may inhibit falsehood and shoddy analysis, or it may lead a witness to bring out information adverse to his position on direct to prevent its disclosure on cross-examination.

If NRC proposes an unsatisfactory rule, a critic of the rule may request that the agency furnish a statement of methodology prior to any final agency action in order to propagate detailed criticism.[241] Such a procedure is exemplified by EPA's process of promulgating effluent limitation guidelines under the Federal Water Pollution Control Act.[242] This is essentially a two-round process in which EPA provides interested persons a technical analysis of the issues prepared by private consultants prior to its initial notice of rulemaking. After the comments on the drafts are received, EPA promulgates its proposed rule and its own draft report attempting to substantiate the proposed rule.[243] This procedure assures EPA that it will be aware of all the complex scientific, technical, and economic issues.

There are disadvantages in using formal rulemaking to reform the nuclear licensing process, expecially in proceedings which involve anything more than the minimum requirements of section 553. Adjudicatory procedures may have the inherent proclivity of encouraging a multiplicity of litigation and propagating ponderous records which tend to frustrate organization. The rule may not be adopted at all, or it may not be adopted as proposed. Additionally, rulemaking proceedings can be very expensive and drawn out, as the ECCS proceeding demonstrated.[244] However, if adversity occurs, industry must have the resolve to finance its

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[240] *Id.* at 443.

[241] Failure to grant such a request may furnish another basis for appeal. *See* notes 67-72 *supra.*

[242] 33 U.S.C. §§ 1257-1265 (Supp. V 1975).

[243] 38 Fed. Reg. 21,202-06 (1973).

[244] *See* Freeman, *The AEC's Recent Experiment in "Evidentiary" Rule Making,* 28 BUS. LAW 663, 669-70 (1973).

commitment and to carry the matter into the courtroom.

There is also a justifiable fear that opponents of nuclear power would use the same tactics in rulemaking proceedings as they use in licensing proceedings. Some nuclear opponents have adopted a "no win" strategy in which the NRC licensing hearings are not viewed in the traditional terms of winning or losing, but are used as a means of achieving another objective—the ultimate demise of nuclear power.[245] The environmentalists may also perceive the hearing as an opportunity to debate the public policy of using nuclear power. To further this aim, proceedings are dramatized to increase media coverage.[246]

Intervenors who oppose the construction of nuclear plants frequently rest their cases entirely on delaying tactics and jurisprudential gymnastics rather than on any substantive legal or factual challenge. Rather than contest factors unique to each plant, such as the adequacy of its radiation safeguards and the expected local environmental effects, some opponents continue to raise the same fundamental questions of fact, such as the basic danger of nuclear power.[247] Such contentions are not really factual, but are policy questions which should be resolved by the NRC in a rulemaking proceeding, not in an individual licensing proceeding.[248] Delay and its consequent expense provide a potent weapon and can be used to force a utility to accept more stringent safeguards or extra equipment designed to further reduce any environmental effects of the plant.[249] Environmentalists may also seek judicial review to provide time to obtain an ultimate resolution through the political process and to engender support by focusing legislative attention on their problems.[250] In this way, benefits from lengthy administrative hearings are maximized

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[245] Like, *Multi-Media Confrontation—The Environmentalists' Strategy for a "No-Win" Agency Proceeding,* 1 ECOLOGY L.Q. 495 (1971).

[246] *Id.*

[247] *See* Murphy, *The National Environmental Policy Act and the Licensing Process: Environmentalist Magna Carta or Agency Coup de Grace?* 72 COLUM. L. REV. 963 (1972).

[248] *See* Note, *The Use of Generic Rulemaking To Resolve Environmental Issues in Nuclear Power Plant Licensing,* 61 VA. L. REV. 869 (1975). Indeed, Congress in enacting the Atomic Energy Act and in funding the NRC each year has determined that nuclear power is "good" and should be encouraged. Such a basic policy issue cannot ever appropriately be before the NRC.

[249] Willrich, *The Energy-Environment Conflict: Siting Electric Power Facilities,* 58 VA. L. REV. 257, 326 (1972).

[250] J. SAX, DEFENDING THE ENVIRONMENT 114 (1971).

even when the chances of an administrative victory are nonexistent. The adoption of adjudicatory procedures in rulemaking proceedings may prompt use of the same or similar tactics.[251]

Rulemaking proceedings can benefit the nuclear industry as well as the opponents. First of all, it is much better to have the NRC use adjudicatory procedures and to request them when appropriate in petitions for rulemaking, than it is to have the resulting rules overturned on appeal because of an inadequate record. For example, more preparation and analysis of the backend of the fuel cycle would have expedited the first uranium fuel cycle rulemaking[252] and, consequently, would have prevented the August, 1976, to December, 1976, nuclear licensing moratorium.[253] The industry should use their resources and do the studies and experiments required to prove the practicability and usefulness of proposed rules. It is better to invest time and resources in this type of rulemaking effort than to be constantly confronted with delay in individual licensing proceedings. If generic rules are adopted, the effectiveness of nuclear opponent's delaying tactics in individual licensing proceedings will ultimately be diminished.

Rulemaking proceedings can also be beneficial to the public.

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[251] Critics of nuclear power have substantially affected the nuclear industry. *See* Freeman, *The AEC's Recent Experiment in "Evidentiary" Rule Making,* 28 Bus. Law 663 (1973). For example, the nuclear opponents used their writings and testimony in licensing proceedings to urge a reduction in the upper limits of radiological effluents from nuclear plants during normal operating conditions. In response to these attacks, utilities volunteered to comply with much lower limits. One utility stated that it would be willing to accept technical specifications limiting its nuclear releases to 1 percent of the existing regulatory (10 C.F.R. § 20 (1977)) levels. This challenge also focused public attention on the critics' exaggerated fears and prompted the AEC to promulgate Appendix I to X C.F.R. § 50, which requires nuclear plants to be constructed and operated so as to hold radioactive releases "as low as practicable."

[252] The NRC adopted table S-3 to quantify the environmental effects of the uranium fuel cycle in the NEPA benefit-cost ratio in individual nuclear power plant licensing proceedings. The portion of this table dealing with disposal of the radioactive wastes was struck down by the District of Columbia Court of Appeals in NRDC v. NRC, 547 F.2d 633 (D.C. Cir. 1977), *rev'd sub nom.* Vermont Yankee Nuclear Power Corp. v. National Defense Council, Inc., No. 76-419 (Sup. Ct. Apr. 3, 1978) because of inadequate development of the administrative record. Even the Supreme Court's reversal of this case did not end the matter, because the Court remanded to determine the adequacy of the record.

[253] Immediately after the decision, the NRC placed a moratorium on licensing of all current nuclear plant applications pending completion of a new rulemaking. 41 Fed. Reg. 34,707 & 34,408 (1976). Shortly after promulgating an interim rule, 41 Fed. Reg. 45,849 (1976), the NRC revoked the moratorium on pending applications, using the interim rule to determine the environmental impact of new plants on the uranium fuel cycle. 41 Fed. Reg. 49,898 (1976).

Broad participation by industry and public interest groups in an adversary-type setting with the consequent airing of a wide range of opinions and factual statements could minimize the possibility of inaccurate determinations in the rulemaking.[254] Such participation would test the premises upon which the proposed rule is based and would increase the chances that the NRC would be apprised of all the relevant facts.[255] This would foster the legitimate aims of the public interest groups, since they could focus their merger resources in one proceeding without resorting to using a "no win" strategy of delay in individual licensing proceedings. From industry's standpoint the more an opponent's resources are beneficially utilized in rulemaking efforts, the less these resources can be used to delay individual proceedings.[256] Additionally, if opponents perceive a fair chance of influencing NRC action, they may make less use of disruptive delaying tactics in subsequent licensing proceedings.[257]

Industry could petition for a number of rules which would make future licensing proceedings more efficient and effective. One obvious example is eliminating the necessity of considering the need for power and alternative methods of generating power at the operating license stage.[258] These matters are fully considered at the construction permit stage and it seems ludicrous to require reconsideration after construction of the plant is completed and it is ready to operate. Another example is elimination of the formal adjudicatory proceedings utilized for the issuance of construction permits and operating licenses. The Atomic Energy Act does not require adjudication;[259] this is only required by NRC regulations.[260] While legislative proposals have been intro-

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[254] *See* Cramton, *The Why, Where and How of Broadened Public Participation in the Administrative Process*, 60 GEO. L.J. 525, 529-30 (1972).

[255] *See* Note, *The Use of Generic Rulemaking To Resolve Environmental Issues in Nuclear Power Plant Licensing*, 61 VA. L. REV. 869, 882 (1975).

[256] *Id.*

[257] *See* Coggins, *The Environmentalist's View of AEC's "Judicial Function,"* 15 ATOM. EN. L.J. (1973).

[258] Such a proposal is contained in the President's nuclear licensing reform proposal. *See* note 3, *supra*.

[259] Bauser, *The Development of Rulemaking Within the Atomic Energy Commission: The Nuclear Regulatory Commission's Valuable Legacy*, 27 AD. L. REV. 165, 169 n.32 (1975). *Cf.* United States v. Florida E. Coast Ry., 410 U.S. 224 (1973); United States v. Allegheny-Ludlum Steel Corp., 407 U.S. 908 (1972).

duced to alter this situation,[261] no legal barrier prevents the NRC from changing the structure of its hearings and not requiring formal adjudicatory hearings in the absence of disputed facts or issues. These are but two suggestions, but many more can be devised. The industry should seriously consider utilizing rule-making as an effective reform technique.

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[260] 10 C.F.R. § 2.761a (1977).

[261] *See, e.g.*, Regulatory Procedures Reform Act, S. 2490, 95th Cong., 2d Sess. (1978) (introduced Feb. 6, 1978, and not yet acted on).

TRANSFERS OF KNOW-HOW UNDER SECTION 351*

BY JOHN L. RUPPERT** AND DAVID K. PANSIUS***

INTRODUCTION

Transfers of technical information, in particular, know-how, by a domestic parent corporation to a controlled foreign subsidiary pose difficult tax problems for the domestic parent. Section 351(a) of the Internal Revenue Code provides that:

> [N]o gain or loss shall be recognized if property is transfered to a corporation by one or more persons solely in exchange for stock or securities[1] in such corporation and immediately after the exchange such . . . persons are in control[2] . . . of the corporation. For pur-

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[1] If the taxpayer fails to receive stock or securities in exchange for the transfer of property, the transaction will likely be treated as an ordinary sale or exchange. Any gain in excess of the adjusted cost of the property transferred will be fully taxable. If, however, the property qualifies as a capital asset under section 1221, and if the requirements of section 1231 or section 1235 are met, a transfer of technology may qualify for special capital gains treatment. See text accompanying notes 54-104 *infra* which discusses this issue with respect to transfers of know-how in conjunction with transfers of patents, secret formulas, and secret processes.

However, in certain circumstances even capital gains treatment will be denied transfers of technology, even though the transaction would otherwise qualify for capital gains treatment. Where the property exchanged is "a patent, an invention, model, or design (whether or not patented), a copyright, a secret formula or process, or any other similar property right," and the transfer is to a foreign corporation "controlled" by the transferor, any gain will be taxed at ordinary rates. Control is defined as "more than 50 percent of the total combined voting power of all classes of stock entitled to vote." I.R.C. § 1249. Thus if a transfer should fail because stock or securities in the transferee was not received in exchange, or because the transferor did not have 80% control of the corporation after completion of the transfer (*see* note 2 *infra* and accompanying text) but had the requisite 50% control, there will be no special capital gains rate applicable to the transfer.

Section 1249 would presumably come into play also when the taxpayer met the requirements of section 351, but failed to comply with the requirements established under section 367 with respect to tax-free transfers of property to foreign corporations. Otherwise, if the transfer qualifies under section 351, there will be no taxable event, and the transaction will not be subject to tax under section 1249. S. REP. No. 1881, 87th Cong., 2d Sess. (1962), *reprinted in* 1962-3 C.B., at 1013. *See* J. BISCHEL, TAXATION OF PATENTS, TRADEMARKS, COPYRIGHTS, AND KNOW-HOW ¶ 6 (1974, Supp. 1976).

[2] Control for the purposes of section 351 is defined in section 368(c) as "the ownership

poses of this section, . . . services shall not be considered as property.

Although in foreign transfers the transferor must also satisfy the reporting requirements under section 367,[3] it is the ambiguous

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of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation."

Note that, under the new rules for section 1491 imposed by the Tax Reform Act of 1976, a transfer which fails to qualify under section 351 may be subject to a 35% excise tax. Section 1491 imposes an excise tax of 35% "on the *transfer of property* by a citizen or resident of the United States, or by a domestic corporation or partnership, or by a trust which is not a foreign trust, to a *foreign corporation as paid-in surplus or as a contribution to capital,* or to a foreign trust, or to a foreign partnership. . . ." The tax is imposed on the difference between the fair market value of the property transferred and the sum of the taxpayer's adjusted basis in the property and the amount of gain recognized to the transferor at the time of the transfer.

The excise tax of section 1491 is not imposed on transfers which qualify for consideration under section 367. I.R.C. § 1492(3). However, one should note that the excise tax applies to transfers of "all types of property." S. REP. No. 94-938, 94th Cong. 2d Sess. 222, *reprinted in* 1976-3 (vol. 3) C.B., at 260. Therefore, if one transfers technology to a foreign corporation, and does not qualify the transfer under section 351 or a related section subject to 367, and the Service considers that the transfer is paid-in surplus or a contribution to capital, the rules of section 1491 will be applicable. A taxpayer can avoid section 1491 through such strategies as electing to be taxed on the latent gain in the property transferred under section 1057; or the transferor may seek an *advance* ruling from the Service that the transfer is not for tax avoidance purposes. I.R.C. § 1492. *See* Alpert & Feingold, *Tax Reform Act Toughens Foreign Transfer Provisions of 1491 and Liberalizes 367,* 46 J. TAX. 2 (1977).

Note further that in any transfer subject to either general taxing rules or the specialized provisions of section 1491, the taxpayer cannot avoid tax by selling the technology for less than fair market value in a transfer, sale, or exchange which is not at arms length. The allocation rules of section 482 will adjust the transfer so that it will reflect "market realities."

[3] Section 367 was created by the Revenue Act of 1932 primarily to foreclose schemes designed to avoid taxation on the appreciation of capital assets. H.R. REP. No. 708, 72d Cong., 1st Sess. 20 (1932); S. REP. No. 665, 72d Cong., 1st Sess. 26-27 (1932). Prior to the Tax Reform Act of 1976, if a taxpayer sought to make a tax-free exchange (under sections 332, 351, 354, 356, or 361) involving a foreign corporation, he would be required, in most instances, to obtain *advance* approval from the Service. The taxpayer had the burden of demonstrating to the Service "that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes." Int. Rev. Code of 1954, ch. 736, 68A Stat. 47, *as amended by* Pub. L. No. 91-681, § 1(a), 84 Stat. 2065 (current version at I.R.C. § 367(a)).

As often happens, the cure can be as distasteful as the disease. The principal problem arising under the above provisions was the hardship which resulted from forcing the taxpayer to await the decision of the Service before he could execute his exchange. If the Service gave an adverse ruling, the taxpayer would have to consider further delaying the transfer until litigation was completed. *See* JOINT COMMITTEE ON TAXATION GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, 94th Cong., 2d Sess. 258, *reprinted in* 1976-3 (vol. 2) C.B., at 270 [hereinafter cited as JOINT COMMITTEE REPORT].

The new rules were thus designed to minimize notice requirements, and where notice is required to make notice procedures more palatable. The Amendments first draw the distinction between transfers into and out of the United States. Transfers out of the United States will still be required to obtain approval of the Service. The taxpayer must demonstrate to the satisfaction of the Service that the "exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes." However, this determination need no longer be made in advance. The taxpayer need only file a request for a determination not later than the close of the 183rd day after the beginning of the transfer. I.R.C. § 367(a)(1). The Act also provides that the Secretary may designate certain out-bound transfers to be exempt from filing requirements, subject to any toll charges arising under section 367. I.R.C. § 367(a)(2). These exemptions from the clearance requirement are to be created for "outbound transfers where significant tax avoidance possibilities do not exist or where the amount of any 367 toll charge can be ascertained without a ruling request." S. REP. No. 94-938, 94th Cong. 2d Sess., at 265, *reprinted in* 1976-3 (Vol. 2) C.B., at 303. A toll charge is in essence an agreement to include in income certain of the items transferred.

> For example, if a section 351 Transfer to a foreign corporation involves only the transfer of cash and inventory property, the Secretary may by regulations designate the transaction as one which does not require the filing of a request, although the regulations would require the inventory to be taken into income.

JOINT COMM. REP. at 261, *reprinted in* 1976-3 (Vol. 2) C.B., at 273.

With respect to inbound transfers, no filing is required. Instead, these transfers will be judged according to regulations published by the Service. I.R.C. § 367(b).

To dissuade the Service from using section 367 as a broad sword to deny nonrecognition status to seemingly permissible potential nonrecognition exchanges, Congress expressly mandated judicial review of the Service's actions. Upon challenge, the Tax Court is to review both the Service's conclusion with respect to tax avoidance in general, as well as any specific conditions imposed by the Service in particular. JOINT COMM. REP. at 261, *reprinted in* 1976-3 (Vol. 2) C.B., at 273.

> The Tax Court is to review whether the Secretary's determination as to tax avoidance is reasonable and whether the conditions imposed in making the determinations are reasonable conditions in order to prevent the avoidance of income tax. If the Tax Court finds that the Secretary's terms and conditions are not reasonable, then the Tax Court is to make a declaration as to the terms and conditions which it finds to be reasonable in order to prevent the avoidance of income taxes.

JOINT COMM. REP. at 262, *reprinted in* 1976-3 (Vol. 2) C.B., at 274. With respect to inbound transfers the Report also states:

> These regulations are to be subject to normal court review as to whether the regulations are necessary or appropriate for the prevention of avoidance of Federal income taxes. Thus, a taxpayer may challenge a proposed deficiency with respect to an exchange dealt with in the regulations by arguing in the courts that the regulations, as applied in the taxpayer's case, are not necessary or appropriate to prevent the avoidance of federal income taxes.

JOINT COMM. REP. at 263-64, *reprinted in* 1976-3 (Vol. 2) C.B., at 275-76.

The Joint Committee emphasizes that section 367 rules are designated to prevent tax avoidance only, and should be applied only to the extent necessary to meet this objective. Although not meant to be exclusive, the committee provided examples of the ills which section 367 was designated to cure:

> Transactions in the first group [outbound transfers] generally include those transactions where the statutory aim is to prevent the removal of appreciated assets or inventory from U.S. tax jurisdiction prior to their sale, while transactions in the second group [inbound transfers] include those where the

language of section 351(a), not the added burden of section 367, which poses the real difficulties for a taxpayer transfering technology to a foreign subsidiary. The current language of section 351(a) generates numerous unanswered questions.[4] Specifically, what forms of technology represent qualifying "property"? What forms of technology are in essence services and thereby excepted from the concept of property by the "services" exclusion in the last sentence of section 351(a)? And finally, what forms of agreements will qualify as actual "transfers" of rights, rather than mere licensing arrangements? Without answers to these questions, a taxpayer must plan his international operations without the benefit of foreknowledge of the tax consequences of his decisions.[5]

> statutory purpose in most cases is to prepare for taxation the accumulated profits of controlled foreign corporations.

JOINT COMM. REP. at 260, *reprinted in* 1976-3 (Vol. 3) C.B., at 272. Presumably, if a transaction does not fit the mold of the prohibited avoidance schemes noted above, the Service cannot use section 367 to deny nonrecognition status to the transfer. Examples of items which the Service will not recognize as tax-free exchanges under section 351 can be found in *Guidelines regarding certain transactions involving foreign corporations requiring an advance ruling under section 367 of the Internal Revenue Code of 1954,* Rev. Proc. 68-23, 1968-1 C.B. 821, 823-25, § 3.02. For a discussion of the proposed regulations under section 367, see Arthur & Paisley, *Section 367: Working With the Temporary Regulations,* 4 INT'L TAX J. 859 (1978). For a review of the new rules under section 367 published prior to the issuance of the Service's proposed regulations on the subject, see Paisley, *Section 367—A Look at the Recent Amendments,* 4 INT'L TAX J. 692 (1977). Alpert & Feingold, *supra* note 2. For an analysis of the Guidelines under section 367, see, e.g., Sitrick, *Section 367 and Tax Avoidance: An Analysis of the Section 367 Guidelines,* 25 TAX L. REV. 429 (1970); Special Committee on Section 367 Policies, Tax Section, New York State Bar Ass'n, *Comments on Guidelines for Rulings under Section 367 Concerning Foreign Corporations,* 23 TAX LAWYER 151 (1969).

4 *See, e.g.,* Cohen, *Long-Awaited Ruling on Transfer of Know-How Sets Guidelines in Important Areas,* 21 J. TAX. 38 (1964); Flyer & Buell, *Tax-free Transfers of Computer Software to Foreign Corps: An Up-to-date Analysis,* 41 J. TAX. 26 (1974); Note, *Transfers of Technical Know-How to Controlled Foreign Corporations,* 5 VA. J. INT'L L. 81 (1964). *See also* Dunn, *The Transfer of Know-how to Controlled Corporations,* 39 TAXES 571 (1961), written prior to the issuance of Rev. Rul. 64-56. *See generally,* Dean, *Transfers to Controlled Corporations: Analyzing The Problem Areas,* 41 J. TAX 72 (1974); Goodman, *How to Avoid Tax Problems Under Section 351 When Transferring Services in Exchange for Stock,* 55 TAXES 112 (1977).

5 Some of the potential penalties of failing to qualify under section 351 are discussed in note 182 *infra.* Although perhaps less likely to occur in the context of foreign transactions, in some circumstances the taxpayer will purposely want to avoid the impact of section 351. *See, e.g.,* Fisher, *The Conversion of Ordinary Income to Capital Gain by Intentionally Avoiding Section 351 of the Internal Revenue Code,* 32 MO. L. REV. 421 (1967); Note, *Careful Tax Planning Avoid 351 for Stepped-Up Basis,* 27 J. TAX 20-21 (1967).

The taxpayer encounters the greatest difficulties when the "property" to be transferred consists wholly or predominantly of technical know-how. Very often, know-how consists of nothing more than information. It may or may not be secret; it may or may not be unique, novel, or original.[6] Very often the information transferred represents little more than accumulated experience, efficiencies, or skills that have been developed over time.[7] Certainly such information is valuable to both the transferor and the transferee.[8] But the test under section 351 is not explicitly one of "value"; it is one of "property."[9] What forms of valuable information can the taxpayer qualify as "property"? Moreover, even overcoming the property hurdle, what rights may the transferor retain in the transferred information while still complying with the transfer requirements under section 351?

This article will examine these questions. In so doing, the authors will attempt to provide clarity to current taxing rules which are at best ambiguous and at worst contradictory. The analysis which follows addresses three major questions: (1) For the purposes of know-how, how broadly have the words "property" and "services" been construed in past tax law decisions; (2) given the courts' treatment of these terms and in light of recent trade secret developments, what specific forms of know-how should qualify as "property" for the purposes of section 351; and, (3) assuming that the information qualifies as "property," what forms of transactions qualify as "transfers" for the purposes of section 351? In general the authors will attempt to highlight those instances where the Internal Revenue Service has misconstrued the letter and the spirit of the words "property," "services," and "transfer," the operative language of section 351.

I. "PROPERTY" AND "SERVICES" WITHIN SECTION 351

As the cynical observer might expect, the Internal Revenue Service has attempted to limit the term "property" to its narrowest construction, while broadening the concept of taxable services

[6] *See* text accompanying notes 162-165 *infra*.

[7] *See* R. MILGRIM, TRADE SECRETS § 2.09[3] (1977); Z. CAVITCH, BUSINESS ORGANIZATIONS § 232.02[2] (1978); MacDonald, *Know-how Licensing and the Antitrust Laws*, 62 MICH. L. REV. 351, 352-55 (1964); text accompanying notes 174-176 *infra*.

[8] *See* text accompanying notes 155-171 *infra*.

[9] The authors later argue that the concept of value and of property are nearly synonomous. *See, e.g.*, text accompanying notes 180-190 *infra*.

to its fullest sweep. The Service's basic approach to the analysis of know-how within the meaning of section 351 is set out in Revenue Ruling 64-56.[10] In this ruling, the Service conceded that items which constitute property in the hands of the transferor will qualify as "property" within section 351. "Once it is established that 'property' has been transferred, the transfer will be tax-free under section 351 even though services were used to produce the property."[11] This statement of course begs the question of what is and is not property. The Service also conceded that secret processes and secret formulas are property for the purposes of section 351.[12] However, as discussed below, there has never been a real dispute as to whether these most protected of trade secrets fall within section 351.[13]

Besides the statement that information "in the general nature of a patentable invention" will be property,[14] the Service provides little definition to the term "property" in the remainder of its ruling. The Service does note that, at a minimum, information must be secret and must receive "substantial" legal protection in order to qualify as a nonrecognition property transfer: "It is assumed for the purpose of this Revenue Ruling that the country in which the transferee is to operate affords to the transferor substantial legal protection against the unauthorized disclosure and use of the process, formula, or other secret information involved."[15] Significantly, however, the Service did not state that the presence in the transferee nation of legal protection is, in itself, sufficient to make secret information property for purposes of section 351. Thus, except for secret processes and secret formulas, the Service stands ready to challenge the "property" status of secret information—even if that knowledge is afforded legal protection as a valuable right: "Other information which is secret will be given consideration as 'property' on a case-by-case basis."[16]

Left without any real guidance as to what constitutes prop-

[10] 1964-1 (Part 1) C.B. 133.
[11] *Id.* at 134.
[12] *Id.*
[13] *See* text accompanying notes 44-52 *infra*.
[14] 1964-1 (Part 1) C.B. at 134.
[15] *Id.*
[16] *Id.*

erty, the taxpayer must cautiously analogize from the Service's list of forbidden services:

(1) Training of the transferee's employees in various skills;
(2) continued technical assistance after the start-up phase;
(3) nonancillary assistance in the construction or layout of a plant, machinery, or equipment; and
(4) other services performed for the transferee which are not merely ancillary or subsidiary to the transfer of property.[17]

This list of recognition transactions indicates that the Service intends to tax at ordinary income rates any transfer that can be catalogued as services to the transferee corporation. The only exception occurs when the services are merely "ancillary and subsidiary" to the transfer of property.[18] Since the term "property" is left substantially undefined, and since the Service intends to tax transfers of services, the taxpayer is forced to anticipate, without guidance, the expansiveness with which the Service intends to apply its definition of services.

Fortunately for the taxpayer, section 351 and the judicial decisions interpreting the statute demand a different analytical approach. From the historical analysis which follows, three basic conclusions emerge: (1) Despite a trend of Service rulings to the contrary, the term "property" is to be given its broadest definition;[19] (2) once transferred information is defined as "property," nonrecognition status is not lost merely because the transfer may be construed as providing services;[20] and, (3) even if the informa-

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[17] *Id.* at 134-35.

[18] *Id.* at 134.

[19] *See* E.I. DuPont de Nemours & Co. v. United States, 471 F.2d 1211, 1218 (Ct. Cl. 1973). *See also* J. BISCHEL, *supra* note 1, at ¶ 6.3; L. ECKSTROM, LICENSING IN FOREIGN AND DOMESTIC OPERATIONS ch. 4 (1977); R. MILGRIM, *supra* note 7, at ch. 1, 2, 6.4. In general, commentators have argued strenuously for the broadest possible definition of the word "property". *See generally* Dunn, *supra* note 4, at 572-73; Flyer & Buell, *supra* note 4, at 30; Nash, *The Concept of "Property" in Know-how as a Growing Area of Industrial Property: Its Sale and Licensing*, 6 PAT., T.M., & COPYRIGHT J. RESEARCH & EDUC. 289 (1962); O'Connor, *Tax Problems on Transfers of Assets to Corporations*, 52 TAXES 756, 758 (1974). For a detailed discussion of this issue, see notes 25-42 and accompanying text *infra*.

[20] *See* Howard S. Gable, 33 T.C.M. (CCH) 1427, 1431-33 (1974); Rev. Rul. 56, 64-1 C.B. 133. *See also* Burke, *Section 351: The Beginning of Life in Subchapter C*, 24 Sw. L.J. 742, 747-56 (1970); Cohen, *supra* note 4; Duffy, *Doing Business Abroad: Use of American Know-How*, 20 N.Y.U. INST. FED. TAX. 1269, 1269-73, 1299-1300 (1962); Dunn, *supra* note 4, at 572-575 (1961); Riebesehl, *Tax Free Incorporations Under Section 351*, 46 TAXES 360, 361-62 (1968); Weiss, *Problems in the Tax-Free Incorporation of a Business*, 41 IND. L.J. 666, 668-670 (1966). For a detailed discussion of this services issue, see notes 30-31, 62-63 and 73-103 and accompanying text *infra*.

tion is in fact services, and not a transfer of property, there will be no adverse tax consequences to the transferor as long as the services are an "incident of" or related to, the transfer of property.[21] In general, the term "services" is to be given its narrowest definition and its most limited impact.[22]

With respect to transfers of know-how, the effect of this conclusion is dramatic. Both the Service and the courts recognize that know-how can be "property" within section 351. Nevertheless, a transfer of know-how in gross, *i.e.* unaccompanied by a transfer of patents, secret processes, or secret formulas, can almost always be construed as little more than the performance of services.[23] Consequently, under the Service's guidelines as formu-

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[21] *See* Howard S. Gable, 33 T.C.M. (CCH) 1427, 1431-33 (1974); Bell Intercontinental Corp. v. United States, 381 F.2d 1004, 1020 (Ct. Cl. 1967); Heil Co., 38 T.C. 989, 1003 (1962). Until recently the commentators have focused almost exclusively on the Service's "ancillary and subsidiary to" language. *See generally* Burke, *supra* note 20, at 747-56; Campbell, *Increasing Profits From Foreign Know-How Licensing,* 45 DEN. L.J. 31, 32-34 (1968); Cohen, *supra* note 4, at 38-40; Duffy, *supra* note 20, at 1270-73, 1299-1300; Flyer and Buell, *supra* note 4, at 29-30; Ladas, *Legal Protection of Know-How,* 7 PAT., T.M., & COPYRIGHT J. RESEARCH & EDUC. 397, 401 (1963); Riebesehl, *supra* note 20, at 361-62; Weiss *supra* note 20 at 668-69. For a detailed discussion of this issue, see notes 56-59, 67-104 and accompanying text *infra.*

[22] *See generally* Note, *Does IRS "Sale or Exchange" Theory Under 351 in Recent Ruling Go Too Far?,* 31 J. TAX. 53, 54 (1969) (The author states that section 351 contains no definition of property. "Services" are excluded under section 351(a) and such a singular and extraordinary exception denotes the only exception to the term "property" under the rule of statutory construction—*expressio unius est exclusio alterius* (expression of one thing is exclusion of another).) *See also* Cohen, *supra* note 4, at 39, where the author notes that the Service's exclusion from property status of information developed for the transferee under section 351 should be construed narrowly, distinguishing the production of information specifically for the transferee from those instances where the transferee benefits only indirectly from the transferor's general research. *See also* notes 67-103 and accompanying text *infra.*

[23] *See generally* Howard S. Gable, 33 T.C.M. (CCH) 1427, 1433 (1974) (in the sale of technical information the buyer is likely to require technical assistance); United States Mineral Prod. Co., 52 T.C. 177, 199 (1969) (assuming arguendo that technical information constituted consulting services). *See also* Cooper, *Tax Aspects of Corporate Exploitation of Inventions and Know How,* 38 So. CAL. L. REV. 206, 206-07 (1965) (know-how is the method of achieving a result); Creed and Bangs, *Know-How" Licensing and Capital Gains,* 4 PAT., T.M., & COPYRIGHT J. RESEARCH & EDUC. 93, 93 (1960) (know-how may involve accumulated technical experience and skills which can best, or perhaps only, be communicated through the medium of personal services); Duffy, *supra* note 20, at 1269-73, 1299-1300 (know-how is inherently a personal attribute, an idea, or a skill, i.e., training and experience); Flyer and Buell, *supra* note 4 (though there are tangible items in trade secrets, technical knowledge is the primary value); Ladas, *supra* note 21 (know-how pertains to the method of achieving a result). For a detailed discussion of this issue, see notes 56-59 and 67-104 and accompanying text *infra.*

lated in Revenue Ruling 64-56, and under even stricter interpretations which followed, a taxpayer must question if the transfer of know-how in gross may ever qualify as a transfer of property if the Service meticulously and mechanically applies its stated standards.[24] However, by broadly defining "property" and by limiting the impact of the services exception, one reaches the opposite conclusion, that the transfer of know-how in gross will qualify as a transfer of property, at least to the extent that the information is generally recognized as a legal protected interest.

A. *The Historically Broad Approach to Section 351*

One source of support for a broad interpretation of the term "property" as used in section 351 may be found in the legislative history behind section 202(c)(3) of the Revenue Act of 1921, the predecessor of section 351(a).[25] In a noteworthy passage from the Senate Report, the purpose of section 202(c)(3) was succinctly stated: The statute fashions new rules of nonrecognition "for those exchanges or *'trades'* in which, although a technical 'gain' may be realized . . . the taxpayer actually realizes no cash profit."[26] Further supporting the Senate Report's interpretation

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[24] Rev. Rul. 56, 1964-1 C.B. 133. For subsequent interpretations and applications of this ruling, see Rev. Proc. 36, 1974-2 C.B. 491 (Rev. Proc. 69-19 is applicable to § 367 rulings on computer software); Rev. Proc. 10, 1973-1 C.B. 760, (general requirements for a ruling under section 351) *superseding* Rev. Proc. 17, 1970-2 C.B. 490; Rev. Rul. 564, 1971-2 C.B. 179 (transfers of trade secrets under section 351 must be exclusive for the entire period prior to the secret's becoming public knowledge); Rev. Proc. 17, 1970-2 C.B. 490; Rev. Proc. 19, 1969-2 C.B. 301 (conditions for a § 367 ruling as to transfers of know-how); Rev. Rul. 156, 1969-1 C.B. 101 (must grant all substantial rights to a sale or exchange of a patent to qualify under § 351). The Service's position prior to Rev. Rul. 64-56 may be found in Rev. Rul. 17, 1955-1 C.B. 388 where the Service ruled that payments for know-how and technical assistance transferred to a foreign corporation constituted royalty income. It is critical to note that the Service specifically found that the services had only nominal value apart from the license to use the know-how. For a detailed discussion of these rulings, in particular Rev. Rul. 64-56 and Rev. Proc. 69-19, see notes 60-67, 121-181 and accompanying text *infra*.

[25] *See* Revenue Act of 1921, ch. 136, § 202(c)(3), 42 Stat. 230 (1921) (current version at I.R.C. § 351(a)). The statute stated: "For the purposes of this title, on an exchange of property, real, personal or mixed . . . no gain or loss shall be recognized . . . (3) when (A) a person transfers any property . . . to a corporation, and immediately after the transfer is in control of such corporation."

[26] *See* S. REP. No. 275, 67th Cong., 1st Sess. 11 (1921). The language of the Senate Report has subsequently been cited with approval in E.I. DuPont de Nemours & Co. v. United States, 471 F.2d 1211, 1215 (Ct. Cl. 1973); Halliburton v. Comm'r, 78 F.2d 265, 269 (9th Cir. 1935); Ralph L. Evans, 8 B.T.A. 543, 546 (1927). *See also* Comment, *Analysis of Revenue Ruling 75-292*, 17 WM. & MARY L. REV. 599, 611 (1976) (a brief discussion of Senate Report 275).

of the new statute, the Hearings before the Senate Finance Committee emphasized that new section 202(c)(3) was aimed at disregarding *merely formal* dispositions that lacked economic or commercial reality.[27] Finally, and perhaps of greatest importance, the Hearings Explanation on the subsequent amendments to section 202 in the Revenue Act of 1924 emphasized that section 202(c)(3) transactions involved no substantial change in ownership, and thus no gain or loss was to be realized until an event equivalent to a sale or exchange occurred.[28] In summary, the historical development of section 202(c)(3) and its successors indicates a legislative concern that lest purely formal and internal corporate rearrangements be impeded, a taxpayer should not be forced to recognize gain or loss when in practical effect he is merely transferring property to himself.

It was not until the passage of the 1954 Internal Revenue Code that Congress added the final sentence of section 351(a), precluding the recognition of services as property.[29] The accom-

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[27] *See Hearings Explanation of 202(c) Before the Senate Finance Committee*, 67th Cong., 1st Sess. 27, 30 (1921). Language similar to that found in the Hearings has appeared in numerous cases. *See, e.g.*, Helvering v. Cement Investors, Inc., 361 U.S. 527, 533 (1941) (section 202(c)(3) designed to permit readjustments); Six Seam Co. v. United States, 524 F.2d 347, 355 (6th Cir. 1975) (aimed at technical transfers only—internal rearrangements); E.I. DuPont de Nemours & Co. v. United States, 471 F.2d 1211, 1213-15 (Ct. Cl. 1973) (aimed at mere form exchanges); Jordan Marsh Co. v. Comm'r, 269 F.2d 452, 457 (2d Cir. 1959) (citing *Portland* and *Trenton*); Barker v. United States, 200 F.2d 223, 228 (9th Cir. 1953) (citing the language in *Portland*); Trenton Cotton Oil Co. v. Comm'r, 147 F.2d 33, 36 (6th Cir. 1945) (citing the *Portland* "mere change in form" language); Portland Oil Co. v. Comm'r, 109 F.2d 479, 488 (1st Cir.), *cert. denied*, 310 U.S. 650 (1940) (where in a popular or economic sense there has been a mere change in the form of ownership); American Compress & Warehouse Co. v. Bender, 70 F.2d 655, 657 (5th Cir.), *cert. denied*, 293 U.S. 607 (1934).

[28] *See* S. REP. No. 398, 68th Cong., 1st Sess. 278 (1924); H.R. REP. No. 179, 68th Cong., 1st Sess. 12 (1924). For further discussion of these Reports, see Comment, *supra* note 26, at 611. *See also* Magill, *Notes on the Revenue Act of 1924 - Income Tax Provisions*, 24 COLUM. L. REV. 836, 841-44 (1924) for a brief review of the 1924 Act's amendments and changes.

As noted above in Comment, *supra* note 26, at 612: "[The] same principle recurs throughout the congressional hearings, debates, and committee reports pertaining to the 1934 amendments, which hold that purely formal 'paper' transactions . . . result in no immediate tax consequences." *See, e.g.*, S. REP. No. 558, 73d Cong. 2d Sess. (1934); H.R. REP. No. 704, 73d Cong., 2d Sess. 13 (1934); *Hearings on Revenue Revision Before the House Ways and Means Committee*, 73d Cong., 2d Sess. 58, 77, 290-91 (1934).

[29] I.R.C. § 351(a) provides that: "For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property." *See also* Treas. Reg. § 1.351.1(a)(1)(i) which states that: "[S]tock or securities issued for services rendered or to be rendered to or for the benefit of the issuing corporation will not be treated as having been issued in return for property . . . ."

panying House Report indicates that the exclusion of services from the definition of property was designed to make the receipt of stock or securities by a transferor who has rendered, or will render, services to the transferee corporation, a fully taxable event.[30] The Report does contain a caveat, however, which states that the committee did not intend the last sentence of section 351(a), the services exclusion, to vitiate the remaining portion of the transaction;[31] bona fide transfers of property were to remain non-tax recognition events.

In contrast to the legislative history behind many other provisions of the Code, the legislative history behind section 351 has played an integral role both in the interpretation of the specific statutory language and the development of a uniformly liberal response to the general purpose underlying the statute. For example, one court has managed to turn the services exclusion in section 351(a) into a basis of support for recognition of a broad definition of the word "property." In *H.B. Zachary Co.*, the Tax Court observed that the known inclusions and exclusions under section 351 (implicitly referring to the services exception) strongly suggested that property encompasses whatever may be

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[30] *See* H.R. Rep. No. 1337, 83d Cong., 2d Sess. (1954), *reprinted in* U.S. Code Cong. & Ad. News 4017, 4254-56.

[31] *Id.* at 4255. The language of House Report 1337 has served as support for numerous attempts by various authors to limit the scope of the services exception. *See, e.g., Burke, supra* note 20, at 750 (distinguishing services to the transferee, services for third parties, and property created by personal services); Cohen, *supra* note 4, at 39 (services for the transferee should be strictly construed); Goodman, *supra* note 4, at 113. (citing the language of House Report 1337); Riebesehl, *supra* note 20, at 362; Weiss, *supra* note 20, at 668-670; Note, *Income Tax - Tax Free Transfers to Controlled Corporations*, 76 W. Va. L. Rev. 401, 404 (1973-74). Numerous judicial decisions have emphasized that "services *for* the transferee" are the main thrust of the exclusion under § 351. *See, e.g.*, Howard S. Gable, 33 T.C.M. (CCH) 1427, 1433-34 (1974) (distinguished nontaxable related services from services rendered to the transferee to create or develop an invention); William A. James, 53 T.C. 63, 67 (1969) (citing House Report 1337); Elihu B. Washburne, 27 T.C.M. (CCH) 577, 591 (1968) (stock issued for the obtaining of an option was issued for services rendered the transferee); Arthur C. Ruge, 26 T.C. 138, 142-43 (1956) (citing *Kimble Glass*, a transferor's obligation to (1) further develop his invention, (2) disclose future inventions to the transferee, and (3) keep the transferee informed of developments in the field were unrelated to the products transferred and therefore were compensable services); Kimble Glass Co., 9 T.C. 183 (1947) (see analysis in *Ruge*, 26 T.C. at 142-43). For further discussion of the "services as property" concept, see notes 63-104 and accompanying text *infra*.

In Rev. Proc. 19, 1969-2 C.B. 301, Rev. Rul. 56, 1964-1 C.B. 133 and Treas. Reg. § 1.351-1(a)(1)(ii) (1954), the Service formally announced its position that services other than "ancillary and subsidiary to" services rendered to the transferee are not property within the scope of section 351.

transferred.[32] Based upon this assertion, the court went one step further and, applying the doctrine of *expressio unius est exclusio alterius* to section 351(a), held that the services exception was the only statutorily supported exclusion to the otherwise broad and general meaning of the term "property."[33]

The court's conclusion in *H.B. Zachary Co.* that "property" is to be given its broadest definition received recognition and support in the 1973 Court of Claims decision, *E.I. DuPont de Nemours & Co. v. United States*.[34] In 1959, the Du Pont Company granted its wholly-owned French subsidiary a royalty-free nonexclusive license to make, use, and sell a patented herbicide formula within the geographic bounds of France. Rejecting the Service's argument which was based upon an unfounded analogy between the word "transfer" in section 1235 and the phrase "transfer . . . in exchange" found in section 351(a), the Court of Claims held that: "[U]nless there is some special reason intrinsic to the particular provision (as there is with respect to the capital gains provisions) the general word 'property' has a broad reach in tax law . . . . For section 351, . . . courts have advocated a generous definition of property . . . ."[35] In an attempt to fashion guidelines delimiting the breadth of this seemingly boundless language, the court emphasized that in this transaction the nonexclusive license itself was commonly thought of in the commercial world as a "positive business asset."[36] *DuPont's* reference to a "positive business asset" test for property is peculiarly well-suited to the analysis of issues involving the transfer of nonpatented and nonpatentable technology, rights often de-

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[32] 49 T.C. 73, 80 n.6 (1967).

[33] *Id.* The *expressio unius est exclusio alterius* argument has been echoed in Note, note 22 *supra;* Note, *Carved Out Oil Payment Constitutes Property For Section 351 Purposes,* 17 OIL & GAS Q. 69, 73-4 (1968). The *Zachary* decision is weakened however by its failure to address the crucial issue; admitting that services are excluded from the definition of "property," what constitutes services?

[34] 471 F.2d 1211 (Ct. Cl. 1973).

[35] *Id.* at 1218. The Service argued that section 1235 (I.R.C. § 1235) which outlines the necessary elements for a patent "transfer" to qualify as a capital asset exchange, also governed the meaning of the words "transfer" and "exchange" under section 351. *Id.* at 1215-18. After rejecting the Service's argument, the court examined the scope of the word "property" only for purposes of section 351. *Id.* at 1218. The *DuPont* rejection of this section 351—section 1235 analogy is discussed in detail in notes 223-229 and accompanying text *infra.*

[36] *Id.*

fined in terms of the "competitive advantage" accruing to their possessor.[37]

Comparably broad language with respect to intangible rights and assets may be found interspersed throughout much of the applicable case law.[38] Citing with approval the *DuPont* decision, the District Court for the Middle District of Georgia, in *Stafford v. United States*,[39] held that, with respect to a lease and loan agreement at interest rates below the market rate, property for purposes of section 351 included any real, personal, tangible, or

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[37] For a discussion of the "competitive advantage" and the "positive business asset" test in trade secret law, see notes 115-190 and accompanying text *infra*. Applying the "positive business asset" test, the *DuPont* court noted: "DuPont handed over something of value and received stock in return . . . ." 471 F.2d at 1219.

[38] The breadth of the *DuPont* property definition is shocking at first glance; nevertheless, *DuPont* is not an isolated or single instance of such liberality. Numerous decisions have espoused a similar test. *See, e.g.*, Max A. Burde, 43 T.C. 252, 269 (1964), *aff'd*, 352 F.2d 995 (2d Cir. 1965), *cert. denied*, 383 U.S. 966 (1966) (property right in an invention comes into existence when it is reduced to actual practice—tested and operated successfully); E.I. DuPont de Nemours & Co. v. United States, 288 F.2d 904, 911 (Ct. Cl. 1961) (a trade secret is property because it conveys more than mere information; it confers an economic advantage); Nelson v. Comm'r, 203 F.2d 1, 6 (6th Cir. 1953) (secret process that was valuable and reduced to tangible form constituted property); Halliburton v. Comm'r, 78 F.2d 265, 269 (9th Cir. 1935) (the word "property" is used without qualification in section 202(c)(3)); George S. Mepham, 3 B.T.A. 549, 553 (1926) (a secret process is property where it is secret, valuable, and successful); Chrome Plate, Inc., 40 AM. FED. TAX. REP. 2d (PH) ¶ 77-5316, 6125 (W.D. Tex. 1977) (citing *DuPont* and *Hempt*, the court held that property should be defined as broadly as possible); Hempt Bros., Inc. v. United States, 354 F. Supp. 1172, 1175 (M.D. Pa. 1973), *aff'd*, 490 F.2d 1172 (3d Cir.), *cert. denied*, 419 U.S. 826 (1974) (property is whatever may be transferred).

See also Duffy, *supra* note 20, at 1270-71 (citing Crane v. Comm'r, 331 U.S. 1 (1947) for the proposition that property is everything that is the subject of ownership); Dunn, *supra* note 4, at 572 (most, if not all, types of know-how constitute property); Ladas, *supra* note 21, at 397-409; O'Connor, *supra* note 19, at 758 (citing the 1973 *DuPont* decision, the author suggests that there is no reason to restrict the definition of property); Riebesehl, *supra* note 20, at 361-62 (trade secrets and patents will ordinarily constitute property, but the secrecy requirement of Rev. Rul. 64-56 is subject to attack); Note, *supra* note 33, at 54 (citing the language of *Zachary* that property is anything that may be transferred). All of the authors have advocated a broad meaning for the word property in an attempt to bring at least trade secrets, if not all that is encompassed under the rubric of know-how, within the scope of section 351.

[39] 435 F. Supp. 1036, 1038 (M.D. Ga. 1977). Interestingly, the Government raised the argument that the agreement between the parties did not constitute a legally enforceable contract and therefore could not constitute "property." In perhaps the most sweeping dicta to date, the court rejected the Government's position stating that the enforceability of the agreement was irrelevant; the parties, believing they were bound, did in fact perform. *Id.* at 1038-39. This language extends beyond even the *DuPont*, 471 F.2d at 1218-19, and *Zachary*, 49 T.C. at 79-80, tests that previously applied only to legally enforceable agreements, i.e., a nonexclusive license of a patent and a royalty agreement, respectively.

intangible rights which the owner thereof could possess, use, or dispose of. Definitions of equivalent breadth may also be found in *Commissioner v. Stephens-Adamson Manufacturing Co.*[40] and *H.B. Zachary Co.*,[41] where the courts held that whatever may be transferred constitutes property. *Hempt Brothers, Inc. v. United States*, a 1974 Third Circuit Court of Appeals decision, has held similarly that property consists of whatever may be sold or assigned.[42] Notwithstanding such generous language, any attempt to analyze the scope of the word "property" for purposes of section 351(a) merely by examining the dicta of past decisions will be misleading. Often, the courts have been more sweeping in their analyses and conclusions than required by the specific factual setting before them.

B. *The Development From Secret Formulas to Know-How*

Despite the plethora of section 351 property cases before the courts in the last fifty years, the body of law concerning trade secrets and know-how under section 351 (in contrast to that concerning patents) has been slow to develop. Both the courts and the Service have struggled to define these intangible rights, as well as to outline the proper tax treatment of their transfers.[43]

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[40] 51 F.2d 681, 683 (7th Cir. 1931) (For purposes of determining the scope of section 202(a) of the Revenue Acts of 1918 and 1921: "We think it a fair definition to say that what may be sold and assigned is property.")

[41] 49 T.C. 73, 80 n.6 (1967) ("Section 351 does not contain a definition of the word 'property.' However, the known inclusions and exclusions strongly suggest that the term encompasses whatever may be transferred.") *See also* notes 32-33 and accompanying text *supra*.

[42] 354 F. Supp. 1172 (M.D. Pa. 1973), *modified*, 490 F.2d 1172, 1175 (3d Cir.), *cert. denied*, 419 U.S. 826 (1974). The court specifically stated that for purposes of section 351, property is whatever may be identified, valued, and transferred. Such language, however, adds little to the lower court's formulation of the test: "Whatever may be transferred." 354 F. Supp. at 1175. Again, the breadth of the *Hempt* test is tempered by the very traditional nature of the property involved, accounts receivables. *Compare* Chrome Plate, Inc., 40 AM. FED. TAX REP. 2d (PH) ¶ 77-5316, 6125 (W.D. Tex. 1977) where the court relied upon *Hempt Bros.* and *DuPont* to support the broad assertion that for purposes of section 351 the courts were unanimous in holding that property should be contrued as broadly as possible. *See also* O'Connor, *supra*, note 19 at 758, where the author argues that there is a strong statutory basis for the *DuPont-Hempt Bros-Chrome Plate* line of developments.

[43] *See* notes 44-104 and accompanying text *infra* for a discussion of the tax developments in the know-how area. The phrase "know-how" appears to be a phenomenon of the last twenty years. As demonstrated by notes 44-52 and accompanying text *infra*, the decisions prior to Rev. Rul. 56, 1964-1 C.B. 133 focused primarily on secret processes and formulas, not know-how. There simply is no use of the phrase "know-how" in the tax law

Focusing more specifically on trade secrets and know-how transfers under section 351(a), the Service and the courts have been most favorable to the transfer of secret formulas[44] and secret processes. As early as 1927, relying on the legislative history of sec-

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until the Service ruled that certain techniques and methods constituted know-how in 1955. See Rev. Rul. 17, 1955-1 C.B. 388. Beginning with Heil Co., 38 T.C. 989 (1962), "know-how" has become a common phrase in the tax decisions. Unfortunately, "know-how" has still not been defined with any specificity. It is the premise of this article that the RESTATEMENT OF TORTS § 757 has implicitly been adopted by the Supreme Court as a definition of the broad term "trade secrets." *See* the discussion at notes 105-121 and accompanying text *infra.* The definition of "trade secret" found in the Restatement appears broad enough to include know-how. Numerous commentators have attempted to fashion a definition of "know-how." *See, e.g.,* Creed and Bangs, *supra* note 23, at 93; Duffy, *supra* note 20, at 1269-73, 1299-1300; Dunn, *supra* note 4, at 572; Nash, *supra* note 19, at 289; Van Notten, *Know-How Licensing in the Common Market,* 38 N.Y.U.L. REV. 525, 526-27 (1963). *See also* BISCHEL, *supra* note 1, at 6-6 to 6-14.

In 1964, nine years after the Service first addressed the issue of know-how in Rev. Rul. 17, 1955-1 C.B. 388, the Service was still uncertain of what know-how meant. See Rev. Rul. 56, 1964-1 C.B. 133 where the Service ruled that: "Since the term 'know-how' does not appear in section 351 of the Code, its meaning is immaterial . . . the Service will look behind the term . . . to determine . . . if . . . the terms . . . constitute property . . . ." In sharp contrast to the Service's inability to define "know-how" in 1964 is Treas. Reg. § 1.482-2(d)(3) where the Service for purposes only of proper allocation of income and deductions among related taxpayers defined intangible property as "(a) Patents, inventions, formulas, processes, designs, patterns . . . . (e) *Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, technical data,* and *other similar items.*" (Emphasis added.)

[44] *See* Edward W. Reid, 50 T.C. 33, 41 (1968) (secret formula constituted property); Pickren v. United States, 378 F.2d 595, 599-601 (5th Cir. 1967) (secret formulas were capital assets under § 1235); Commercial Solvents Corp., 42 T.C. 455, 467 (1964) (a secret process is a capital asset as well as property); E.I. DuPont de Nemours & Co. v. United States, 288 F.2d 904, 910 (Ct. Cl. 1961) (Government conceded that secret processes constituted property); Nelson v. Comm'r 203 F.2d 1, 6 (6th Cir. 1953) (secret processes may constitute property); Ruth Neuberger v. United States, 69-1 U.S. Tax Cas. ¶ 9264, 84166 (D. Ore. 1968) (secret formulas are property); Stalker Corp. v. United States, 209 F. Supp. 30, 33-34 (E.D. Mich. 1962) (trade secrets constitute property); Huckins v. United States, 60-1 U.S. Tax Cas. ¶ 9394, 76091-92 (S.D. Fla. 1960) (secret process treated as a capital asset under section 1221).

For further recognition of secret formulas as property, see generally Benjamin, *Tax Aspects of Operating a Possession Corporation in Puerto Rico,* 2 INT'L TAX. J. 197, 200-01 (1976); Cohen, *supra* note 4, at 38; Dunn, *supra* note 4, at 572 n.2; Hilinski, *Is the IRS Blocking the Tax-Free Transfer of Know-How to Foreign Corporations?,* 23 J. TAX. 305, 305-06 (1965); Nash, *supra* note 19, at 94-99; Riebesehl, *supra* note 20, at 361-62.

The Service, since 1964, has officially recognized that secret formulas constitute property for purposes of section 351. *See, e.g.,* Rev. Rul. 564, 1971-2 C.B. 179 (trade secret remains valuable and therefore constitutes property only so long as it remains a secret); Rev. Proc. 19, 1969-2 C.B. 301, (the Service requires that the taxpayer represent that the information he seeks to transfer pursuant to sections 351 and 367 is secret, known only by certain confidential employees, and is adequately safeguarded); Rev. Rul. 56, 1964-1 C.B. 133 (property for purposes of section 351 includes secret processes and formulas).

tion 202(c)(3), the Board of Tax Appeals, in *Ralph L. Evans,* held that a corporate transfer of a secret hair-dye formula constituted property for purposes of section 202(c)(3).[45] One year earlier, in *George S. Mepham,* the Board had accorded capital asset status to (and ultimately capital gains treatment to the sale of) a secret fume-trapping process.[46] Again in 1948, the Tax Court, in *Wall Products, Inc.,*[47] advanced the burgeoning analysis one step fur-

[45] 8 B.T.A. 543 (1927). The Board succinctly disposed of the issue as to whether or not the secret formula constituted property by the overly simplistic statement: "It is admitted that he transferred the secret process to the Delaware corporation." *Id.* at 547. *See also* William A. James, 53 T.C. 63, 68-69 (1969) where, based on *Evans,* the court recognized that secret formulas constituted property for purposes of section 351, but held such analysis inapposite to the transfer of purely services. The *Evans* decision was subsequently cited by the Service in Rev. Rul. 56, 1964-1 C.B. 133, 134, to support the Service's acquiescence as to secret processes and formulas. *Evans* was also subsequently interpreted more broadly than its language might support when Flyer and Buell noted that both *Evans* and Wall Products, Inc., 11 T.C. 51 (1948) are framed in terms of trade secrets generally being property. Flyer and Buell, *supra* note 4, at 27 n.14. This analysis may be questionable in light of the fact that both decisions dealt explicitly with secret formulas only. *See also* notes 46 and 47 *infra,* and note 44 *supra.*

[46] 3 B.T.A. 549, 553 (1926). The Board emphasized three factors: The process (1) was clearly secret, (2) had proven to be successful, and (3) was never patented. *Id. Mepham* was subsequently cited as support for the broad statement in United States Mineral Prod. Co., 52 T.C. 177, 196-97 (1969), that the courts have long recognized industrial knowledge and secret formulas, reduced to practice, as property. Although *Mepham* has been cited in the case law only infrequently, it has received wide recognition in the legal literature. *See, e.g.,* Cooper, *How a Corporation Can Get Capital Gains When Licensing Inventions and Know-How,* 24 J. TAX. 334, 334-35 (1966) (*Mepham* held a secret manufacturing process to be intangible property); Duffy, *supra* note 20, at 1271 n.7; Sugarman, *Incorporating Tax Free - Basic Requirements Under Section 351 of the Internal Revenue Code,* 12 CASE W. RES. L. REV. 183, 186 (1961) (*Mepham* cited for the broad proposition that goodwill, know-how, and trade secrets qualify as property under section 351).

[47] 11 T.C. 51, 57 (1948). The specific product involved was a highly successful concrete-curing formula. *Id.* at 52-55. The court observed that without the inventor's technical skills, manufacture of the product would have been impossible. *Id.* at 54. Recognizing that a secret formula may constitute property, the court rejected the Service's argument that application for a patent was a requisite element to a finding of property status. *Id.* at 57. Subsequent attempts by the Service to make property status contingent on the existence of a patent application have also been rebuffed. *See, e.g.,* Max A. Burde, 43 T.C. 252, 269 (1964) *aff'd,* 352 F.2d 995 (2d Cir. 1965), *cert. denied,* 383 U.S. 966 (1966); Franklin S. Speicher, 28 T.C. 938, 944-45 (1957); Samuel E. Diescher, 36 B.T.A. 732, 743-44 (1937), *aff'd,* 110 F.2d 90 (3d Cir.), *cert. denied,* 310 U.S. 650 (1940); Comm'r v. Stephens-Adamson Mfg. Co., 51 F.2d 681, 683 (1931). Similarly to *Evans,* (see discussion in note 45 *supra*) *Wall Prod.* was cited with approval in Rev. Rul. 56, 1964-1 C.B. 133, 134. It is interesting to note that in United States Mineral Prod. Co., 52 T.C. at 197, *Mepham* was distinguished from *Wall Prod.* on the grounds that the former was an industrial knowledge case, while the latter was purely a secret formula decision. *Compare also* Cooper, *supra,* note 46, at 335, (*Wall Prod.* recognized that a secret formula may constitute property) and Duffy, *supra* note 20, at 1271 n.7 (*Wall Prod.* held a secret

ther, holding that the property right in a patentable, but as yet unpatented, secret formula was not negatived by a failure to file a patent application. Finally, in 1961, in *E.I. DuPont de Nemours and Co. v. United States*, the Service conceded that the transfer of a secret process constituted the transfer of property.[48]

In light of the Government's concession in *DuPont*, it came as little surprise in Revenue Ruling 64-56[49] that the Service ruled property to include such items as secret processes, secret formulas, and secret information concerning devices or processes without regard to the existence of a patent or the patentability of the asset in question.[50] Again the Service's concession as to un-

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formula to be property), *with* Flyer and Buell, *supra* note 4, at 27 n.14, where the authors interpreted *Wall Prod.* as applicable to the broader field of trade secrets as defined by the RESTATEMENT OF TORTS § 757 (1939). *Id.* at 28-29.

[48] 288 F.2d 904, 910 (Ct. Cl. 1961). Despite the Service's recognition that secret formulas constituted property, the taxpayer failed to meet the "sale or exchange" requirement of sections 117, 1221, and 1231. *Id.* at 906-909. For further discussion of what constitutes a "transfer" under section 351, see notes 197-241 and accompanying text *infra*. The decision in the 1961 *DuPont* case has subsequently served as the foundation for any extension of the property concept to include know-how and trade secrets related to transferred patents. *See, e.g.*, E.I. DuPont de Nemours & Co. v. United States, 471 F.2d 1211, 1215-20 (Ct. Cl. 1973); Francis H. Shepard, 57 T.C. 600, 611-18 (1972), *rev'd*, 481 F.2d 1399 (3d Cir. 1973) (unpublished opinion), *cert. denied*, 417 U.S. 911 (1974); Taylor-Winfield Corp., 57 T.C. 205, 214 (1971); PPG Indus., Inc., 55 T.C. 928 (1970); United States Mineral Prod. Co. 52 T.C. 177, 199 (1969); Commercial Solvents Corp. 42 T.C. 455 468 (1964); Pickren v. United States, 249 F. Supp. 560, 561 (M.D. Fla. 1965), *aff'd*, 378 F.2d 595 (5th Cir. 1967); Stalker Corp. v. United States, 209 F. Supp. 30, 33 (E.D. Mich. 1962); Rev. Rul. 564, 1971-2 C.B. 179, all know-how decisions citing the 1961 *DuPont* decision.

[49] Rev. Rul. 56, 1964-1 C.B. 133.

[50] *Id.* at 134-35. In summary the Service ruled that "The term 'property' for purposes of section 351 of the Code will be held to include anything qualifying as 'secret processes and formulas' . . . and any other secret information as to a device, process, etc., in the general nature of a patentable invention without regard to whether a patent has been applied for . . . and without regard to whether it is patentable in the patent law sense . . . ." The Service, in Rev. Proc. 19, 1969-2 C.B. 301, 302, subsequently defined secret information as that information "known only by the owner and those confidential employees who require the 'information' . . . and adequate safeguards have been taken to guard . . . against unauthorized disclosure, and (b) . . . the 'information is original, unique, and novel." To date, only Howard S. Gable, 33 T.C.M. (CCH) 1427, 1433 n.3 (1974); William A. James, 53 T.C. 63, 68 (1969); and Bell Intercontinental Corp. v. United States, 381 F.2d 1004, 1020 (Ct. Cl. 1967) have even mentioned Rev. Rul. 64-56 expressly; to date no court has cited Rev. Proc. 69-19. For further discussion of the "absolute secrecy" versus the "relative secrecy" doctrines, see notes 122-154 and accompanying text *infra*.

Numerous tax commentators have also questioned the need for an "absolute secrecy" doctrine. *See, e.g.*, Benjamin, *supra* note 44, at 201 (contrasting Rev. Proc. 69-19, with the language of *DuPont*, 471 F.2d at 1218); Cohen, *supra* note 4, at 38 (secrecy is questionable in light of the 1961 *DuPont* decision, 288 F.2d at 910-12); Duffy, *supra* note 19, at patented secret devices or processes, in addition to secret formulas, was merely the formal recognition of an already clear line of judicial developments. Therefore, the Service's seemingly broad concession on the patentability issue was less an act of spontaneous generosity and more an official recognition of a demonstrated judicial receptiveness toward transfers of such items. For example, in 1940, in *Samuel E. Diescher*, the Third Circuit Court of Appeals held that an inventor's property right in his invention was not dependent upon his obtaining a patent, but rather existed as a result of his reduction of the invention to practice.[51] Seventeen years later in *F.S. Speicher*, the Tax Court stated that the unpatented inventions in question constituted property, for the transferor had a completed conception of his invention and had previously expressed it in the form of drawings and a physical machine.[52] In retrospect, there has been little if any resistance to the recognition of unpatented secret formulas and secret devices as property for purposes of section 351(a).

The courts, however, have yet to address the issue of what

1271-72 (secrecy alone should not be the test for whether an asset constitutes property); Riebesehl, *supra* note 20, at 362 (whether secrecy should be an element at all); Weiss, *supra* note 20, at 669 (citing Duffy, *supra* note 19, the author questions the need for a secrecy element).

For a detailed discussion of the "unique, novel and original" test, see notes 155-171 and accompanying text *infra*.

[51] 39 T.B.A. 732, 743-44 (1937), *aff'd*, 10 F.2d 90 (3d Cir.), *cert. denied*, 310 U.S. 650 (1940). There is interesting language in *Diescher* to the effect that the inventor's rights in his invention were common law rights. *Id.* at 743. The court cited with approval Six Wheel Corp. v. Sterling Motor Truck Co., 50 F.2d 568 (9th Cir. 1931), where the Ninth Circuit stated: "From the foregoing, it will be seen that the irreducible quantum of the inventor's right in the res, even under the common law, is that of making, using and vending . . . . The statutes (referring to the patent laws) certainly do not curtail the natural right; they enlarge it." *Id.* at 571. From the specific facts before the court, i.e., transfer of an unpatented but nevertheless patentable invention, *Diescher* has come to be interpreted so broadly as to support the proposition that industrial knowledge and secret formulas reduced to practice constitute property. *See* United States Mineral Prod. Co., 52 T.C. 177, 196 (1969). One author has cited *Diescher* for the proposition that the products of a man's mind are property whether they are tangible or intangible. *See* Duffy, *supra* note 19, at 1271. *See also* note 47 *supra* for further discussion of the concept of unpatented inventions as property.

[52] 28 T.C. 938 (1957). The court rested its analysis on Edward C. Myers, 6 T.C. 258, 265-66 (1946), an earlier decision where the Tax Court held that an invention becomes a property right when it reaches the "completed conception stage." 28 T.C. at 945. The *Diescher-Speicher* test has also been used in Max A. Burde, 43 T.C. 252, 269 (1964), *aff'd*, 352 F.2d 995 (2d Cir. 1965), *cert. denied*, 383 U.S. 966 (1966); Nelson v. Comm'r, 203 F.2d 1, 6 (6th Cir. 1953); Comm'r v. Stephens-Adamson Mfg. Co., 51 F.2d 681, 682-83 (7th Cir. 1931).

forms of know-how or compilations of information, in and of themselves, will qualify as property under section 351(a). To date, the success of taxpayer-transferor attempts at transfering technical information or know-how has hinged solely upon the relationship between these rights and the other recognized forms of property transferred.[53] Except for a few early cases, the majority of decisions addressing specifically the know-how issue have been post-Revenue Ruling 64-56 decisions. One of the earliest decisions to address the issue of whether know-how constituted a capital asset was the 1947 Tax Court decision *Kimble Glass Co.*[54] In *Kimble* the transferor conveyed the rights to manufacture and sell specific items under a German patent in conjunction with the transferor's agreement to diligently develop his invention, to keep the transferee informed of developments by others in the field, and to submit to the transferee any offers or proposals he might obtain for subsequent licensing of these rights. As might be expected, the court found all of these latter rights to constitute services rather than property.[55] Nine years later the Tax Court, in *Arthur C. Ruge,* cited *Kimble Glass Co.* for the proposition that requiring an inventor to (1) further develop his inventions, (2) transfer future improvements to the transferee, and (3) use his best efforts to promote and develop the particular business involved constituted the performance of services resulting in ordinary income to the transferor.[56] More importantly however, the court found that an agreement to provide a specific number of man days of consulting service per year was "ancillary and subsidiary to" the assignments of the inventions and was "of the type

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[53] One reason the courts have examined these assets from the perspective of their interrelationship generally with patents is because the courts have not yet been faced with the issue of transfers of know-how in gross. In fact, to date the courts have continued to struggle with fleshing out the precise meaning of the phrase "know-how." *See* note 43 *supra.* For a detailed discussion of the requisite degree of interrelationship, see notes 56-104 and accompanying text *infra.*

[54] 9 T.C. 183 (1947).

[55] *Id.* at 186. However, petitioner entered into two agreements with a German business. The first agreement provided for the sale of certain patented articles, certain machines for the manufacture of these articles, the furnishing of manufacturing and improvement information, and the training and supplying of a mechanic. *Id.* at 185. In contrast to the items in the second agreement, the court found *none* of these items in the first agreement to constitute the performance of services. *Id.* at 191.

[56] 26 T.C. 138, 143 (1956). The court noted: "In the instant case, we are of the opinion that the services called for by paragraph 6 . . . are similar to those held to be personal services in *Kimble Glass Co.*, . . . and . . . therefore constitute(s) ordinary income."

and kind usually called for to implement the sale of highly technical and intricate inventions," and consequently afforded the "services" property status.[57]

Ruge, therefore, represents the initial formulation of a black-letter-rule for determining when certain assets, expressly recognized as the performance of services, are sufficiently related to other traditionally recognized forms of property transferred to be accorded property status under section 351(a). The greatest contribution of the *Ruge* decision was not its formulation of the "ancillary and subsidiary to" test, but rather its generous and liberal interpretation of the general "property" requirement under section 351. The court in *Ruge* went so far as to grant property status to assets that were inherently nothing more than the performance of services, *i.e.* consulting assistance. A close examination of the *Ruge* test, therefore, reveals that the court was less concerned with formulating a definition of what constitutes property and more concerned with formulating guidelines identifying the requisite relationship or nexus between property and services so as to qualify the entire package for section 351 treatment.[58] Thus, the "ancillary and subsidiary to" test offers little in the way of guidance to the taxpayer seeking to catalogue his assets as qualifying property or nonqualifying services. The true value of the test rests in its offer of property status, regardless of the nature of the assets or services, if the requisite relationship between those services and the recognized forms of property transferred exists.[59]

Taken at face value, the early rulings of the Service con-

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[57] The specific purpose of the consulting services was to assist in the establishment of subsequent control over the manufacturing operations of the actual inventions transferred. *Id.* at 139. Compare these services with those items found not to constitute services in *Kimble Glass Co. See* note 55 *supra*. It is interesting to note that assets clearly classed as services within the agreements themselves were treated as property. *See* note 58 *infra*.

[58] In both *Ruge* and *Kimble Glass Co.*, the dichotomy between "ancillary and subsidiary to," and unrelated, services was quite clear. In both cases, information and even services directly related to the implementation of other recognized forms of property transferred were given property status. *See* notes 55 and 57 *supra*. *See also* text accompanying note 57 *supra*. In contrast, in these early decisions, services or information only indirectly linked to the tangible property transferred, such as general future improvements, other developments in the field, and future licensing offers, were denied property status. 26 T.C. at 142-43.

[59] The decade following Rev. Rul. 64-56 has witnessed a continuing struggle to identify this requisite relationship. *See* notes 67-72, 101 and accompanying text *infra*.

formed with the initial approach taken by the court in *Ruge*. In Revenue Ruling 64-56, the Service attempted to formulate guidelines as to when know-how constitutes property for purposes of section 351(a).[60] The Service rejected the contention that the mere reduction of know-how to documentary form automatically accorded the information property status.[61] In an attempt to be more specific, the Service noted further that once an item was found to be property, the fact that services were involved in the production of that item did not constitute grounds for denying property status to the entire transfer unless the items transferred had been specifically developed for the transferee.[62] However, recognizing that know-how may inherently consist of both property and services, the Service adopted language identical to the *Ruge* test, ruling that only those services that were "ancillary and subsidiary to" the property transferred would be treated as "property."[63]

The Service soon retreated from its stance taken in Revenue Ruling 64-56. Over the flexible and very liberal language of the former ruling, the Service, in Revenue Procedure 69-19, grafted more onerous requirements for determining whether the transfer

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[60] Rev. Rul. 56, 1964-1 C.B. 133. *See* note 10 *supra*.

[61] *Id.* at 134. To support its position, the Service cited Harold L. Regenstein, 35 T.C. 183 (1960), where the Tax Court found that the information and transfer of a group life insurance concept constituted only the rendering of services, not property. The Service's reliance on this case is questionable, however, for as the *Regenstein* court stated, all that was involved was a release by the transferor of any claim he might have had for compensation for his services in developing the plan. 35 T.C. at 191. It is doubtful that the case may be read as broadly as the Service urged.

[62] Rev. Rul. 56, 1964-1 C.B. at 134. It is interesting that the Service again opted to rest its position upon *Regenstein*, 35 T.C. 183 (1960) rather than H.R. Rep. No. 1337, *supra* note 30, at 4254-56. *See also* notes 11 and 12 and accompanying text *supra*. One explanation for such analysis may be found in the breadth of the *Regenstein* holding in contrast to the language found in House Report 1337. In fact, the court in *Regenstein* never addressed the issue of whether the plan or idea could be treated as property because in the court's opinion the petitioners actions constituted only services. 35 T.C. at 190-91.

[63] Rev. Rul. 56, 1964-1 C.B. at 134-35. The Service gave the following examples of what constituted "ancillary and subsidiary to" services: (1) promoting the transaction by demonstrating and explaining the use of the property; (2) assisting in the effective starting-up of the property; (3) performing under a start-up guarantee; or (4) further educating the transferee's employees already possessing a modicum of basic skills. In contrast the Service ruled that the following information failed the "ancillary and subsidiary" test: "(1) training transferee's employees in new skills; (2) continuing technical assistance; and (3) assistance in the construction of plants, machinery housing, or plant layouts." *See* note 17 and accompanying text *supra*. For a more detailed discussion of the ruling, see Cohen, *supra* note 20. *See also* notes 122-179 and accompanying text *infra*.

or know-how would qualify as a section 351(a) property transfer under the prior approval requirements of section 367.[64] First, the Service ruled that transferable information must be secret, unique, novel, and original.[65] In addition, the Service hinted at the severity with which it intended to apply these new rules by declaring that mere knowledge or efficiency gained from experience or skill was not to be considered property, while reiterating its position that the mere reduction of know-how to documentary form was not sufficient to afford such material property status.[66] Thus, by giving qualifying know-how its narrowest construction, the Service necessarily broadened its concept of services and limited the impact of its "ancillary and subsidiary to" exception.

In contrast to the Service's position, the courts' reactions to know-how transfers have generally reflected a desire to broaden the scope of those "services" which will qualify as property at least when the transfer is in some way connected to the transfer of related patents, secret formulas, or secret processes.[67] From *Ruge* through *Howard S. Gable,*[68] a span of almost twenty years, the courts have gone through four subtle, and oftentimes indistinguishable phases. From *Ruge,* in 1956, through Revenue Ruling 64-56, the case law and revenue rulings are analyzed solely in

[64] Rev. Proc. 19, 1969-2 C.B. 301. On its face Rev. Rul. 64-56 appears to be quite liberal. There is little in the ruling foreshadowing a restrictive prospective application. *See* notes 60-63 and accompanying text *supra.*

[65] *Id.* at 302. *See also* notes 14-16, and accompanying text *supra* and notes 155-171 and accompanying text *infra.*

[66] *Id.* In addition, the Service restated all of the exclusions formulated in Rev. Rul. 64-56, note 63 *supra.* Finally, the Service's two new exclusions in subsections .03(b) and (g) of the Procedure: (1) "The 'information' does not represent mere knowledge, or efficiency resulting from experience, or mere skill in manipulation or total accumulated experience and skill of the transferor . . . and (2) "Technical information of a related or similar nature such as new developments in the field will not be furnished on a continuing basis without adequate compensation . . . ." could be interpreted as inconsistent with Rev. Rul. 64-56. For a critical analysis of the Service's retreat in Rev. Proc. 69-19, see 70-20 TAX MANAGEMENT MEMORANDUM (BNA), 8-11 (Oct. 5, 1970). *See also* notes 172-179 and accompanying text *infra.*

[67] For a general discussion of the court's approaches, see J. BISCHELL, *supra* note 1, at ¶ 6.3a-c; B. BITTKER AND J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, 3-13 (3d ed. 1971); Burke, *supra* note 20, at 747-56 (little doubt that intangibles constitute property); Cohen, *supra* note 20, at 38-40 (reference to information developed for the transferee should be construed strictly); O'Connor, *supra* note 19, at 757-58 (cases support a broad definition of property). *See notes* 68-104 and accompanying text *infra* and notes 56-67 *supra.*

[68] 33 T.C.M. (CCH) 1427 (1974).

terms of the "ancillary and subsidary to" test.[69] From 1962 through approximately 1970, in the face of the Service's contraction of the "ancillary and subsidiary to" test, a noticeable judicial shift occurred, not in the flexibility and liberality of the courts' approach to section 351 know-how transfers, but rather in the specific language used by the courts to attain that result. Suddenly an "incident to" test was espoused to enforce the liberal standard inaugurated in *Ruge,* but subsequently misinterpreted by the Service.[70] From 1970 through 1974, the courts experienced a transition period, struggling with the apparent deficiencies of both the "ancillary and subsidiary to" test and the "incident to" test, when confronted with the issue of transfers of know-how only indirectly related to recognized forms of property transferred under section 351.[71] Finally, in 1974, the *Gable* decision marked the rudimentary beginnings of a final phase. Still reflecting the judicial liberality with which know-how transfers had been analyzed since *Ruge, Gable* formulated a new variation on the "ancillary and subsidiary to" test: the "related to" test.[72] The following section of this article will attempt to clarify these nebulous and often overlapping phases by a brief review of the major cases representing each mode of analysis.

Heil Co., a 1962 Tax Court decision was one of the first attempts to determine if a transfer of patents and accompanying know-how could qualify for capital gains treatment.[73] Although decided prior to the release of Revenue Ruling 64-56, *Heil Co.* was decided after the Service announced it was currently reviewing

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[69] *Ruge* represents the initial formulation of the "ancillary and subsidiary to" test. There appear to have been no decisions discussing this test until Heil Co., 38 T.C. 989 (1962). By this time, however, the Service had announced it was reviewing the entire area. Prior to the release of Rev. Rul. 64-56 there was nothing to foreshadow an interpretation of the "ancillary and subsidiary to" test by the Service other than that endorsed in *Ruge.*

[70] Beginning with *Heil Co.,* notes 73-78 and accompanying text *infra,* a clear inconsistency arose between the liberal language of Rev. Rul. 64-56 and the Service's actual position. Despite the flexibility hinted at in the ruling, the Service in *Heil Co.,* notes 73-78 *infra, Bell Intercontinental Corp.,* notes 78-79, *infra, United States Mineral Products Co.,* notes 81-86 *infra,* and *PPG Industries, Inc.,* notes 89-91 *infra,* took highly mechanical and conservative anti-know-how positions. The Service's ruling in Rev. Proc. 19, 1969-1 C.B. 301 epitomized this dramatic contrast.

[71] By the 1971 decisions, *Taylor-Winfield Corp.,* and *Francis H. Shepard,* notes 92-94 *infra,* there is little if any mention in the opinions of any requisite degree of relationship between the know-how transferred and the other forms of property transferred.

[72] 33 T.C.M. at 1433. *See* notes 93-99 and accompanying text *infra.*

[73] 38 T.C. 989 (1962).

the know-how transfer guidelines.[74] The specific technical information transferred in *Heil Co.* consisted of assembly drawings, customer lists, notes on manufacturing operations, expert assistance, future developments, and research.[75] Holding that none of this information constituted the performance of services, the Tax Court opined that because the know-how in question was pertinent to the successful use of the patents transferred, it took on the nature of, and was an "incident to", those patents, and therefore was entitled to capital gains treatment.[76] Despite the difference in language, the *Heil Co.* "incident to" test differs little in result or method of analysis from the *Ruge* "ancillary and subsidiary to" test.[77] In fact, the two tests as used in *Heil Co.* seem to be synonomous. The major advantage of the "incident to" test however is its expansion of the *Ruge* test to include past, present, and even *future* services.[78]

Heil Co. was followed in 1967 by *Bell Intercontinental Corp. v. United States.*[79] Again, as in *Heil Co.*, the issue was not a section 351 transfer, but rather whether know-how in conjunction with certain patents qualified as a capital asset under the general

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[74] *See* T.I.R. 308, 1961 IRB 13, 21.

[75] 38 T.C. at 993. In addition, Heil Co. was willing to make its engineers and experts available for consultation with the transferees employees. *Id.* at 993-94. All of this information related to the development of certain heavy construction machinery.

[76] *Id.* at 1003. The court noted that, after reviewing the contract, it was unable to discover any provisions which provided for the rendering of services by petitioner to the transferee. *Id.* at 1002. With respect to future information, the court simply refused to interfere with the parties' own evaluation of the nature and worth of the rights transferred. *Id.* at 1003.

[77] *Compare* text accompanyng note 57 *with* note 75 and accompanying text *supra.*

[78] The past services consisted of Heil's own efforts to develop the information; the present services consisted of consultation with Heil's engineers and experts; and finally, the future services consisted of any future developments or improvements. *Id.* at 993-998.

Heil Co. has served as the cornerstone in the development of the concept of know-how transfers and the issue of whether they constitute property. The Service has issued guidelines as to what will not be considered "ancillary and subsidiary to" services. *See* notes 60-63 and accompanying text *supra.* In effect *Heil* foreshadowed a recognition as property of many of the forms of information subsequently denied property status under the Service's rulings and procedures. Using the phrase "incident to" rather than "ancillary and subsidiary to," the court found that engineering and manufacturing assistance, design improvements, notes on manufacturing operations, and commercial and manufacturing data were capital assets regardless of their temporal relation, past, present or future, to the actual transfer. Therefore, the greatest benefit of the "incident to" test was its broadening of the temporal relationship between the actual transfer and earlier or subsequent service-oriented developments. For further analysis of the "incident to" test, see notes 79-91 and accompanying text *infra.*

[79] 381 F.2d 1004 (Ct. Cl. 1967).

capital gains sections 1221 and 1222. As in *Heil Co.*, the information involved consisted of manufacturing and engineering data, and the Court of Claims, finding such know-how to constitute a capital asset, again relied upon the "incident to" test rather than the "ancillary and subsidiary to" test of Revenue Ruling 64-56.[80] *Bell,* like *Heil Co.*, represents a sharply different attitude toward the scope of section 351 from that urged by the Service.

In 1969, in *United States Mineral Products Co.*, the Tax Court reviewed the applicability of the capital gains provisions, specifically section 1221, to the transfer of manuals, reports, quality control procedures, tests, data, and other documents to a wholly-owned Canadian subsidiary.[81] Attempting to reconcile the widening gap emerging between the interpretation by the *Heil Co.* and *Bell* decisions of the "incident to" test and the Service's dogged adherence to a very restrictive view of the "ancillary and subsidiary to" test, the Tax Court noted that because the know-how in question was unique to and necessary for effective utilization of the patents transferred, it was an "incident of" the patents.[82] Continuing, the court stated: "Assuming *arguendo* that this information was equivalent to consulting services . . . we find that it was of the type usually called for to implement the sale of highly technical inventions and, thus, was ancillary and subsidiary to the assignments of the formulas."[83] It is interesting to note that the court's use of the "ancillary and subsidiary to"

[80] Bell executed agreements with Agusta concerning the transfer of certain patents and production know-how including manufacturing and engineering data for production of a helicopter. Curiously, in light of the court's reliance upon the "incident to" test, the court found that the know-how transferred was not dependent upon the patent drawings. *Id.* 1019-20. Unfortunately, the court did not identify the specific items constituting the know-how. Additionally, it is important to note that the court relied exclusively on the *Heil Co.* "incident to" test with only an oblique reference to Rev. Rul. 64-56. *Id.* at 1020. Clearly, the "incident to" test was seen as a more flexible alternative to the restrictive interpretation by the Service of Rev. Rul. 64-56's guidelines.

[81] 52 T.C. 177 (1969). Specifically, petitioner transferred formulas, processes, patents, manuals containing technical information, consultation with the transferee's employees as to the use of all information transferred, disclosure of all future inventions and improvements during the term of the agreement, and an agreement to conduct, publish, and publicize future test results on the products. *Id.* at 179-80.

[82] "Without these products a proper application of the . . . products would have been difficult or impossible. This information was an incident of the patents and assumed their nature as capital assets." *Id.* at 199. Again as in *Bell,* note 80 *supra,* the court refused to apply the Service's version of the "ancillary and subsidiary to" test.

[83] *Id.*

test was more conclusory than analytical. Only after analyzing the know-how in terms of the "incident to" test did the court feel any obligation to express its result in language acceptable to the Service.[84] Nevertheless, this broadening of the "ancillary and subsidiary to" test by reliance upon the "incident" test was clearly contrary to the position urged by the Service.[85] Also noteworthy was the fact that the court cited *Ruge* and Revenue Ruling 55-17, rather than Revenue Ruling 64-56, in support of its broad interpretation of the "ancillary and subsidiary to" test.[86]

Subsequent to the decision in *Mineral Products Co.*, the Service released Revenue Procedure 69-19.[87] Although the Procedure made no mention of *Mineral Products* or its predecessors, it did break new ground for section 351 transfers of know-how by providing that: (1) The information must be secret in the strictest sense of the word; (2) it must represent a discovery that is origi-

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[84] 52 T.C. at 199.

[85] *See* notes 80 and 82 *supra*. The information transferred probably ran afoul of Rev. Rul. 56, 1964-1 C.B. 133, because not all of it was secret, it constituted technical assistance after the start-up phase, and was merely educational in nature. *See* the discussion of Rev. Rul. 64-56 and Rev. Proc. 69-19 in notes 60-63 and 64-66 *supra*, and notes 122-179 and accompanying text *infra*.

[86] Interestingly, the cited support for the "ancillary and subsidiary to" test was Arthur C. Ruge, 26 T.C. 138 (1956) and Rev. Rul. 17, 1955-1 C.B. 388, not Rev. Rul. 56, 1964-1 C.B. 133. Without any reference to "ancillary and subsidiary to" services, Rev. Rul. 55-17 simply ruled:

> The right to use such 'know-how' is not materially different from the right to use . . . secret processes and formulae, and, if the right thereto is granted as part of a licensing agreement, it becomes, in effect, an integral part of the bundle of rights acquired. . . .
>
> The payments made . . . are applicable both to . . . the 'know-how', and to services performed . . . in instructing and training the employees . . . . Since the personal services have only nominal value apart from the license to use such 'know-how,' all but a nominal sum should be allocated to the license.

Id. at 389.

Ruge is more directly on point and its initial interpretation and formulation of the "ancillary and subsidiary to" test is more nearly approximated by the "incident of" test of *Heil Co.* and *Mineral Products*. The *Ruge* court stated: "The consulting services . . . were ancillary and subsidiary . . . to the inventions . . . and are of the type and kind usually called for to implement the sale of highly technical and intricate inventions." 26 T.C. at 143. One may speculate that the *Mineral Products* court's reliance on the "incident to" language represented an attempt to maintain the breadth of the "ancillary and subsidiary to" test as originally formulated in *Ruge* but subsequently erroneously reinterpreted by the Service in Rev. Rul. 64-56. *Compare* text accompanying note 83 *supra with Ruge*, 26 T.C. at 143.

[87] Rev. Proc. 19, 1969-2 C.B. 301.

nal, unique, and novel; and (3) following from the two requirements above, the information may not represent mere knowledge or efficiency gained from experience or skill.[88] Immediately following the release of Revenue Procedure 69-19 the Tax Court was again faced with the issue of the proper treatment of the transfer of patents and accompanying know-how, in *PPG Industries, Inc.*[89] Referring both to the Service's "ancillary and subsidiary to" test and the "incident to" test, the court recognized that even after-acquired information may come within the *Heil* and *Mineral Products Co.* "incident to" test for property[90] under section 1211 of the Code. As in *Heil Co.*, the court's use of the "ancillary and subsidiary to" test in conjunction with the "incident to" test reflected both an implicit rejection of the Service's highly mechanical and restrictive interpretation of the *Ruge* test, in Revenue Ruling 64-56, and a continued adherence to the more liberal approach developed in prior decisions.[91]

A major step forward came in the 1971 decision *Taylor-Winfield Corp.* where, without citation of any past case law, the court simply asserted that it was "settled" that the transfer of unpatented technology, such as know-how, could be the subject of a sale, and that technical data should be treated, for section

[88] *Id.* at 302. *See* the brief discussion of the Procedure in note 66 *supra*. For a detailed discussion of Rev. Proc. 69-19 see generally Burke, *supra* note 20, at 755; Flyer and Buell, *supra* note 4, at 27-28; TAX MANAGEMENT MEMORANDUM, *supra* note 66. Though the Procedure does not expressly so state, many of its new prohibitions strike directly at the developments in *Heil Co.*, *Bell Intercontinental Corp.*, and *Mineral Products*. *See* notes 73-85 and accompanying text *supra*. *See also* notes 122-179 and accompanying text *infra*.

[89] 55 T.C. 928 (1970). The assets transferred to the corporation consisted of patents, trade secrets, research and development data, technical information and know-how, including engineering, scientific and practical information and formulae, manufacturing data and procedures, machinery, plant and equipment designs, information or materials and commercial sources thereof, technical information in reports and drawings, blueprints, and specifications, along with all such future information coming into the possession of the transferor during the term of the agreement. *Id.* at 975, 977, 979-80, 983.

[90] The court cited with approval the applicability of the *Heil Co.* "incident to" test even for information conveyed after the date of the agreement. *Id.* at 1015-16. Referring to *Heil Co.* and *Mineral Products*, the court referred to the "ancillary and subsidiary to" test but clearly applied something more akin to the earlier discussed "incident to" test. Interestingly, the court found that the materials in question implemented the patented and unpatented information transferred, and made possible the effective utilization of such technology. The court reasoned therefore that the materials were "ancillary and subsidiary." *Id.* at 1018. In *PPG*, the court used the more liberal test to find that certain know-how constituted property but relied upon the more restrictive test to phrase its conclusions.

[91] *See* notes 73-78 and 80 and accompanying text *supra*.

1235 capital gains purposes, in a manner similar to patents.[92] Again, the nature of the know-how transferred was similar to that transferred in the earlier discussed decisions and probably came within the prohibitions of Revenue Procedure 69-19.[93] Interestingly, no mention was made of the procedure. Tempering the broad language employed by the court, however, was the fact that in conjunction with the transfer of know-how, Taylor-Winfield did transfer certain patents and processes. Addressing the "transfer" issue, the court emphasized that the value of these patents was not insignificant.[94]

The most recent Tax Court examination of the know-how issue occurred in 1974, in *Howard S. Gable*. Citing all of the earlier discussed opinions, the court, in an ambiguously worded opinion, advanced a new "related to" test and interpreted it very liberally.[96] Addressing an issue often avoided in the past, the court noted that underlying any patent transfer is a transfer of knowledge, knowledge a transferee is likely to require to imple-

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[92] 57 T.C. 205, 213 (1971). The specific information transferred consisted of engineering data, designs, research, developments, drawings, layouts, reports and any future developments and patents. *Id.* at 207.

It is interesting to note that by disregarding the patents transferred, and looking at the know-how in isolation, *Taylor-Winfield* recognized that technical data is to be treated similarly to patents. *Id.* Conspicuously missing in the opinion is any reference to a requisite relationship between patented and unpatented materials transferred. *Id.* at 217.

[93] *Compare* notes 57, 75, 80, 81 and 89 and accompanying text *with* notes 63-66 and accompanying text *supra.*

[94] 57 T.C. at 217.

Taylor-Winfield was followed by *Francis H. Shepard*, 57 T.C. 600 (1972), *rev'd* 481 F.2d 1399 (3d Cir. 1973) (Unpublished Opinion), *cert. denied*, 417 U.S. 911 (1974). In *Shepard* the lower court examined the transfer in question and found that the payments made were only in consideration for certain technical information including drawings, designs, and blueprints. The lower court accorded this technical information capital asset treatment. *Id.* at 609-615. It is difficut to ascertain whether the decision was reversed on this ground. In contrast to all the cases prior to *Shepard*, including *Taylor-Winfield, Shepard* was the first to favorably address technical information in gross, although the court was careful to note that all of the information transferred related to a patented invention covered in the original agreement but never actually transferred to the transferee. *Id.* at 612-615. The precedential value of *Shepard* however is highly questionable in light of its unexplained reversal.

[95] 33 T.C.M. (CCH) 1427 (1974).

[96] *Id.* at 1433. The court formulated a test even more flexible and liberal than the "incident to" test. The court held: "The rule is to be applied to exempt from treatment as services not only the communication of existing know-how, but the development of further information *as long as it relates to the property* transferred and constitutes assistance rendered in connection with the transfer." (Emphasis added.) *Id.*

ment and develop the property transferred.[97] Recognizing the necessity of this know-how to the value of the property transferred, and distinguishing services specifically related to an invention from services meant only to advance the transferee's business in a general sense, the court afforded property status to that information "related to" the property transferred.[98] In summary, *Gable* must be viewed with caution because of the extremely imprecise language employed by the court. Nevertheless, the "related to" test perhaps marks the beginning of a broader approach to know-how transfers that may be sufficiently flexible to encompass even transfers of know-how in gross.[99]

In retrospect, the post-1964 know-how decisions reveal a judicial willingness to stretch the language of Revenue Ruling 64-56 to its broadest and most liberal limits, and to ignore the more conservative gloss put on the ruling by the Service in Revenue Procedure 69-19.[100] The decisions have evidenced an increasing liberality toward section 351 transfers of know-how. From *Heil Co.*, in which the touchstone test focused on the degree of dependence of the know-how transferred upon the other property in the transaction, the Tax Court has progressed and broadened its analysis by means of the "related to" test. In effect, *Gable* may foreshadow an analytical framework focusing not predominantly on the property aspects of the transferred patents alone, but rather on the independent property status of each of the rights transferred, both patents and know-how.[101]

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[97] *Id.*

[98] The specific information transferred by Gable consisted of inventions, compounds, processes, improvements thereon, technical information, patents, and an agreement to continue further work, development, and experiments. *Id.* at 1429. The court termed the "essence of the transaction" the sale of a patent, and the performance of any services only a step in developing the property transferred. *Id.* at 1432.

[99] *See* note 101 and accompanying text *infra.*

[100] To date, the courts have simply ignored Rev. Proc. 19, 1969-2 C.B. 301.

[101] In *Heil,* discussion in notes 73-78 and accompanying text *supra,* the very nature of the "incident to" test required a two-step analysis. First the court examined the transaction to determine if property has been transferred. Only after answering the first question in the affirmative did the court address the second issue, that is, whether any non-property assets (i.e., know-how) in and of themselves, are incidental to the successful utilization of the property transferred. This pattern repeats itself in *Bell, Mineral Products,* and *PPG Industries,* discussed at notes 78-79, 81-86 and 89-91 and accompanying text *supra.*

A subtle shift in language and focus occurred in *Taylor-Winfield,* 57 T.C. 205 (1971) and the lower court decision in *Francis H. Shepard,* 57 T.C. 600 (1972) *rev'd,* 481 F.2d

Certainly this method of analysis is at odds with the restrictive reformation of the Service's position found in the most recent revenue rulings and procedures.[102] Perhaps the best example of the ever-widening divergence of the Tax Court decisions and the Service's published position may be seen in the area of transfers of future services. In *Gable*, the court noted that earlier decisions had recognized that the development of further information for the transferee by the transferor, as long as it "related to" the earlier transferred property, was still exempt from treatment as services under section 351.[103] Although an accurate statement of prior case law, this statement is totally contrary to the Service's position as expressed in both Revenue Ruling 64-56 and Revenue Procedure 69-19: Technical information of a related or similar nature such as new developments in the field may not be furnished on a continuing basis to the transferee without adequate compensation (in other words, ordinary income treatment).[104] Admitting this is only one of many examples of the conflict between the Service's guidelines and the case law devel-

1399 (3d Cir. 1973) (Unpublished Opinion), *cert. denied*, 417 U.S. 911 (1974) (stating that unpatented technology by itself could be the subject of a sale and that "technical data" should be treated for tax purposes similarly to patents.) Interestingly, the information involved in *Taylor-Winfield* was not an incident of a patent, but only related to unpatented items. *See* note 92 *supra*. In *Shepard*, a patent, involved in the license agreement, was never transferred. *See* note 94 *supra*.

By 1974, the court had come full circle. In *Gable*, 33 T.C.M. (CCH) 1427 (1974), by recognizing that in any transfer of technical information and know-how, knowledge constitutes a large part of the transfer, the court implicitly shifted its perspective to recognize that know-how itself is deserving of property status coequal with that of patents. A transfer of technical information is more than simply a separate transfer of patents and dependent know-how in the same agreement; the transfer is one of interrelated and interdependent coequal property components; in effect, the transfer is a package of property assets. Consequently, the "related to" test removes the stigma of dependence or market inferiority attached to know-how by the "incident to" or "ancillary and subsidiary to" tests, and in its place recognizes the distinct and separate property aspect of know-how in and of itself. To support this analysis, *see* Flyer and Buell, *supra* note 19, at 26, 29.

[102] *See* notes 24, 60-66 *supra*.

[103] 33 T.C.M. (CCH) at 1433. In *Heil Co.*, 38 T.C. at 993-94, the Tax Court included as property the furnishing of future consultation services relating to the inventions transferred. *See* notes 75-78 *supra*. Similar treatment was given an agreement for future consultation, and future developments and improvements in *Mineral Products*, 52 T.C. at 199. *See* notes 81-86 *supra*. *See also Shepard*, 57 T.C. at 605, *rev'd*, 481 F.2d 1399 (3d Cir. 1973) (Unpublished Opinion), *cert. denied*, 417 U.S. 911 (1974) (future inventions and improvements); *Taylor-Winfield*, 57 T.C. at 209 (future developments and improvements); *PPG, Inc.*, 55 T.C. at 1015 (future services and the *Heil Co.* decision).

[104] Rev. Proc. 19, 1969-2 C.B. 301. *See also* notes 64-66 and accompanying text *supra*, and notes 172-179 and accompanying text *infra*.

opments, it is perhaps the most dramatic example of the near total rejection by the courts of the Service's unfounded and arbitrary distinction between services and property for purposes of section 351.

II. Know-How in Gross: Property as Defined by Federal Law

The tax decisions discussed in the preceding section indicate that anything which by law constitutes property, should also represent property for purposes of section 351. In *E.I. DuPont de Nemours & Co. v. United States,* the Court of Claims defined property as "that commonly thought of in the business world as a positive business asset."[105] *DuPont* was followed four years later by *Stafford v. United States* in which the Middle District Court of Georgia broadened the *DuPont* property definition to include any real or personal, tangible or intangible property, or any asset which the owner has a right to possess, own or dispose of.[106] Admittedly, property may not, and probably should not, be defined so broadly as to include anything which may represent a benefit to the parties, a definition foreshadowed by the broad dicta in *Stafford.*[107] However, at a minimum, property for purposes of section 351 should encompass everything which is generally recognized as a legally protected interest; the specific holdings in *DuPont* and *Stafford* mandate no less.

The "legally protected interest" construction of the term "property" provides the taxpayer with an arsenal of weapons with which to attack the only restrictive pronouncements of the Service. The vast majority of states define legally protected information in terms of the Restatement of Torts, section 757, defining "trade secret": A trade secret may consist of any formula, pattern, device or compilation of information which is used in one's business, and which gives him an opportunity to obtain an advantage over competitors who do not know or use it.[108] As will be noted below, recent nontax federal cases have also endorsed this definition of legally protected information. Since the broad concepts of "property" expressed in *DuPont* and *Stafford* must at

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[105] 471 F.2d at 1218. *See* the discussion in notes 34-37 and accompanying text *supra.*

[106] 435 F. Supp. at 1038. *See* the discussion in note 39 and accompanying text *supra.*

[107] 435 F. Supp. at 1038-39.

[108] Restatement of Torts § 757, comment b (1939) *See generally* Klein, *The Technical Trade Secret Quadrangle: A Survey* 55 Nw. U.L. Rev. 437 (1960).

least encompass legally protected interests and since federal courts define legally protected information in terms of the widely employed Restatement of Torts definition of "trade secret," must not this definition also be binding on the Service for the purpose of determining qualifying know-how transfers under section 351? In this fashion, the Restatement can be employed to provide clear guidelines to the taxpayer as to what forms of know-how will and should be granted property status. The analysis which follows attempts to outline the specific instances where, contrary to the Service's pronouncements, know-how transfers should qualify as property for the purpose of section 351.

At one time serious questions existed as to whether any nonpatented intellectual property could be protected by the states. Arguments were made that *Lear, Inc. v. Adkins*[109] stood as a precedent for the rule that federal patent law preempted state trade secret law.[110] This controversy was put to rest by the Supreme Court in *Kewanee Oil Co. v. Bicron Corp.*[111]

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[109] Lear, Inc. v. Adkins, 395 U.S. 653 (1969).

[110] In *Lear* the Court expressly refused to rule on the issue of whether royalties legally could be collected for the license of a trade secret. The Court, however, intimated that its ruling with respect to licensee estoppel might cast a broader shadow on trade secret law: "Our decision today will, of course, require the state courts to reconsider the theoretical basis of their decisions enforcing the contractual rights of inventors and it is impossible to predict the extent to which this re-evaluation may revolutionize the law of any particular State in this regard." *Id.* at 675.

Viewed in terms of such earlier decisions as Sears, Roebuck & Co. v. Stiffel Co., 376 U.S. 225 (1964) and Compco Corp. v. Day-Brite Lighting, Inc., 376 U.S. 234 (1964), many commentators expressed doubt as to whether state protection of trade secrets could survive a challenge based upon preemption by the federal patent laws. Kewanee Oil Co. v. Bicron Corp., 478 F.2d 1074 (6th Cir. 1973), *rev'd*, 416 U.S. 470 (1974); Painton & Co. v. Bourns, Inc., 309 F. Supp. 271 (S.D.N.Y. 1970), *rev'd*, 442 F.2d 216 (2d Cir. 1971); Adelman & Jaress, *Inventions and the Law of Trade Secrets After* Lear v. Adkins, 16 WAYNE L. REV. 77 (1969); Arnold and Goldstein, *Life Under* Lear, 48 TEXAS L. REV. 1235 (1970); Milgrim, *Sears to Lear to Painton: of Whales and Other Matters*, 46 N.Y.U. L. REV. 17 (1971); Note, *Federal Preemption of State Trade Secret Law: Existing Theories and a Proposed Solution*, 24 CASE W. RES. L. REV. 799 (1973); Note, *The Viability of Trade Secret Protection After* Lear v. Adkins, 16 VILL. L. REV. 551 (1971). Doerfer, *The Limits on Trade Secret Law Imposed by Federal Patent and Antitrust Supremacy*, 80 HARV. L. REV. 1432 (1967). *See* Hawkland, *Some Recent American Developments in the Protection of Know-How*, 20 BUFF. L. REV. 119 (1970). *See also* Doerfer, *The Limits on Trade Secret Law Imposed by Federal Patent and Antitrust Supremacy*, 80 HARV. L. REV. 1432 (1967); Note, *The Scott Amendment to the Patent Revision Act: Should Trade Secrets Receive Federal Protection*, 1971 WIS. L. REV. 900.

[111] 416 U.S. 470 (1974).

The *Kewanee* Court made two important determinations: (1) that states had the power to protect intellectual property,[112] and (2) that specific state protections, at least when in conformity with the Restatement of Torts definition of trade secret, did not conflict with the federal patent laws.[113] The Court reasoned that federal patent protection and the Restatement's protection of trade secrets were complementary, serving the same purpose of promoting business invention and efficiency.[114] As a result, state protection of trade secrets, as enunciated by the Restatement, is not only permissible but desirable.[115] In other words, compilations of information meeting the standards of the Restatement can and should represent a legally protected interest. Viewed in terms of the *Hempt Bros.* and *Stafford* cases, which state that any rights

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[112] 416 U.S. at 478-79. *See* Sears v. Gottschalk, 502 F.2d 122, 132 (4th Cir. 1974), *cert. denied*, 422 U.S. 1056 (1975); Richter v. Westab, Inc., 529 F.2d 896, 901 (6th Cir. 1976); Analogic Corp. v. Data Translation, Inc., 358 N.E.2d 804 (Mass. 1976).

[113] 416 U.S. at 491. *See* Painton & Co. v. Bourns, Inc., 442 F.2d 216 (2d Cir. 1971). See the following commentaries for discussions of the *Kewanee* holdings: Stern, *A Reexamination of Preemption of State Trade Secret Law after* Kewanee, 42 GEO. WASH. L. REV. 927 (1974); Note, *Survival of State Protection for Trade Secrets*, 28 ARK. L. REV. 491 (1975); Note, *Trade Secrets: Federal Patent Law Does Not Preempt State Laws Protecting Trade Secrets Which, Although Appropriate Subjects for Patent Protection, Are Ineligible for Patent Protection Because They Have Been in Public Use for More Than One Year*, 41 BROOK. L. REV. 682 (1975); Note, *State Trade Secret Protection is not Preempted by Operation of United States Patent Law*, 12 HOUS. L. REV. 191 (1974); Note, *Constitutional Law—Patents and Trade Secrets—Federal Patent Law Does Not Preempt State Trade Secret Law*, 51 N.D. L. REV. 212 (1974); Note, *Trade Secrets - Federal Patent Code Does Not Preempt State Trade Secret Statutes*, 28 RUT. L. REV. 191 (1974); Note, *Constitutional Law - Patent Clause - Status May Afford Trade Secret Protection Without Infringing Upon Federal Patent Power*, 20 VILL. L. REV. 225 (1974); Note, *Accommodation of Federal Patent and the State Interest in Trade Secrets*, 16 WM. & MARY L. REV. 171 (1974); Note, *Patent Law - No Federal Preemption of State Trade Secret Law*, 1974 WIS. L. REV. 1195.

[114] "Trade secret law will encourage invention in areas where patent law does not reach, and will prompt the independent inventor to proceed with the discovery and exploitation of his invention. Competition is fostered and the public is not deprived of the use of valuable, if not quite patentable, inventions." 416 U.S. at 485

[115] The Court discusses the need for state trade secret protection as follows:

> Trade secret law encourages the development and exploitation of those items of lesser or different invention than might be accorded protection under the patent laws, but which items still have an important part to play in the technological and scientific advancement of the Nation. Trade secret law promotes the sharing of knowledge, and the efficient operation of industry . . . . Congress, by its silence over these many years, has seen the wisdom of allowing the States to enforce trade secret protection.

416 U.S. at 493.

which can be possessed, used, or transferred represent property, *Kewanee's* endorsement of trade secret protection in general, and the Restatement in particular, should serve to establish minimum guidelines with respect to what forms of secret information transfers will be granted nonrecognition status under section 351(a).

Indeed, subsequent decisions have cited *Kewanee* for the rule that the Restatement represents the federal definition of a protected trade secret. Faced with the task of construing "trade secret" for the purpose of the Freedom of Information Act, the Ninth Circuit relied on *Kewanee's* reference to the Restatement: "The Supreme Court has defined 'trade secret' as it applies to the patent laws as a 'compilation of information' which is used in one's business, and which gives him an opportunity to obtain an advantage over competitors who do not know or use it."[116] In another case addressing the scope of the Freedom of Information Act, the District Court for the District of Columbia, quoting from *Kewanee,* stated that the court "must make a threshold determination whether such materials fall within the 'widely relied-upon definition of trade secret found at 4 *Restatement of Torts* § 757, comment b (1939).' "[117] Similarly, in those instances where the court has not specifically addressed local law,[118] or where local law is in doubt,[119] the Restatement inevitably emerges as the standard the court applies in defining what constitutes a protected trade secret. These post-*Kewanee* decisions, by specifically adopting the Restatement's definition of protected information for the pur-

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[116] Union Oil Co. of Calif. v. FPC, 542 F.2d 1036, 1044 (9th Cir. 1976). *See* Rel-Reeves, Inc. v. United States, 534 F.2d 274, 297 (Ct. Cl. 1976) (citing both the Restatement of Torts and *Kewanee* for what is protectable as a trade secret property right under an armed service procurement regulation defining "proprietary data"); Truck Equipment Service Co. v. Fruehauf Corp., 536 F.2d 1210, 1215 (8th Cir. 1976), *cert. denied,* (In a case involving unfair competition under the Lanham Act, the court cited *Kewanee* for the proposition that those who invest time and money in the development of goodwill should reap the benefits of their energy); Pharmaceutical Man. Ass'n v. Weinburger, 411 F. Supp. 576, 580 (D.D.C. 1976) (assessing the propriety of a FDA regulation by comparing it to the Restatement of Torts definition of trade secret).

[117] Ashland Oil Inc. v. FTC, 409 F. Supp. 297, 303 (D.D.C.), *aff'd* 548 F.2d 977 (D.C. Cir. 1976).

[118] Timely Prods. Corp. v. Arron, 523 F.2d 288, 303 (2d Cir. 1975); Telex Corp. v. I.B.M. Corp., 510 F.2d 894 (10th Cir.), *cert. dismissed,* 423 U.S. 802 (1975); Kodeky Elecs., Inc. v. Mechanex Corp., 486 F. 2d 449 (10th Cir. 1973).

[119] Tri-Tron Int'l v. Velto, 525 F.2d 432, 436 (9th Cir. 1975); Keystone Plastics, Inc. v. C&P Plastics, Inc., 506 F.2d 960, 964 (5th Cir. 1975); K-2 Ski Co. v. Head Ski Co., Inc., 506 F.2d 471, 473 (9th Cir. 1974).

poses of federal law, reinforce the conclusion that *Kewanee* requires that the Service recognize the Restatement standards of what information represents property. *Kewanee's* endorsement of the Restatement, when construed together with the broad definition of property in *DuPont* and *Stafford* must therefore bind the Service to the Restatement's definition of protected information for purposes of section 351. As demonstrated in Part II, there has been little controversy over whether secret formulas or secret patterns and devices (*i.e.* secret processes) are recognized as property. Similarly, cases interpreting section 351 seem to hold that virtually any valuable compilation of information will also qualify as property when the information transfer is an "incident of" the transfer of patents, secret formulas, or secret processes. The unanswered question is what forms of know-how, *independent of any patents or trade secrets,* will qualify as property. By applying the Restatement to section 351 this question is answered as well.

To illustrate the impact of the Restatement, the analysis which follows highlights those specific positions taken by the Service which cannot withstand judicial attack when judged against the Restatement. Specifically, the authors will address two fundamental tests which the Service apparently requires that the taxpayer meet before a know-how transfer will be granted nonrecognition status under sections 351 and 367: (1) The information must be absolutely secret, that is, known only to the owner and employees who use it; and (2) in addition to being a discovery, the information must be original, unique and novel. Admittedly these tests apply only to the limited issue of whether a transfer will be granted prior approval under the now obsolete advance notice rules of section 367.[120] In light of the Tax Reform Act's recent adoption of a post-transfer review procedure, the standards expressed in Revenue Procedure 69-19 may no longer necessarily reflect the Service's position with respect to what forms of know-how will qualify under section 351. However, since the requirements articulated in the Revenue Procedure appear to be designed to supplement the ambiguous rules expressed in Revenue Ruling 64-56, the Revenue Procedure must substantially reflect the Service's position with respect to section 351 as well.

[120] *See* note 3 *supra* for the changes in section 367 implemented by the Tax Reform Act of 1976.

Indeed a careful reading of the Procedure commands this conclusion.[121]

The authors will demonstrate how neither the "absolute secret" nor the "unique and novel" tests can stand as appropriate guidelines for what should constitute property under section 351(a) when compared against the Restatement. Having reached this conclusion, the authors will further highlight how other more specific positions taken by the Service with respect to know-how also must give way in the face of contrary legal authority.

A. *Must the Information Be Absolutely Secret?*

Although Revenue Ruling 64-56 requires information to be secret before it will be granted property status,[122] it was not until Revenue Procedure 69-19 was issued that the Service stated what it meant by "secret." First, "adequate safeguards" must have been taken "to guard the secret against unauthorized disclosure."[123] This demand for adequate safeguards presumably does not differ materially from the common law requirement that the owner take "reasonable" precautions under the circumstances to protect his secret.[124] However, the Service's second requirement

[121] The Revenue Procedure demands that the taxpayer represent that the information is property under section 351 as defined by Revenue Ruling 64-56, and that the information is protected under U. S. law, the law of the transferor. The Procedure then states: "In making such representations the taxpayer should . . . state" that the information is absolutely secret and that it is original, unique, and novel. 1969-2 C.B. at 302. Since "such representations" must refer to the property and protection requirements, one must necessarily assume that the dual tests which follow represent the Service's interpretation of governing U.S. law.

[122] In Revenue Ruling 64-56 the Service stated that property consists of secret processes, secret formulas, and secret information "in the general nature of a patentable invention . . . . Other information which is secret will be given consideration as 'property' on a case-by-case basis." 1964-1 (Part 1) C.B. at 134.

[123] 1969-2 C.B. at 302.

[124] R. MILGRIM, *supra* note 7, § 2.04 at 2-26 to 2-27 (1977); *See, e.g.*, K-2 Ski Co. v. Head Ski Co., 506 F.2d 471, 474 (9th Cir. 1974); Structural Dynamics Research Corp. v. Engineering Mechanics Research Corp., 401 F. Supp. 1102, 1110 (E.D. Mich. 1975); Allen Mfg. Co. v. Loika, 145 Conn. 509, 144 A.2d 306, 310 (1958); Space Aero Prods. Co., Inc., v. R. E. Darling Co., 238 Md. 93, 208 A.2d 74, *cert. denied*, 382 U.S. 843 (1965); Sun Dial Corp. v. Rideout, 16 N.J. 252, 108 A.2d 442 (1954); General Analine & Film Corp. v. Frantz, 50 Misc.2d 994, 272 N.Y.S.2d 600, 606, *judgment modified*, 52 Misc.2d 197, 274 N.Y.S.2d 634 (Sup. Ct. 1966).

The Restatement of Torts mentions "the extent of measures taken by him to guard the secrecy of the information" and "the extent to which it is known by employees and others involved in his business" as two of the six factors to consider in evaluating whether a trade secret exists. RESTATEMENT OF TORTS § 757 at 6. Significantly the Supreme Court that the information be "known only by the owner and those confidential employees who require the 'information' for use in the conduct of the activities to which it is related. . . ."[125] deviates substantially from the standards expressed in the Restatement. This "absolute" view[126] of secrecy can derive only from the Service's fundamental misinterpretation of the proprietary interests embodied in a trade secret, in general, and know-how, in particular.

The Service has attempted to impose upon trade secrets and know-how tests appropriate only for patents.[127] Patent rights and trade secret rights are fundamentally different concepts requiring fundamentally different rules of analysis. A patent is a grant of an absolute monopoly. The invention is a secret until a patent application is approved, whereupon the invention is publicly disclosed. In exchange for disclosure, the Government grants the inventor a monopoly in the invention, limited to a seventeen-year term.[128] The patentee's monopoly includes the right to prevent independent creation and use of the invention.[129]

A trade secret is information of sufficient competitive value so that one who does not know the information cannot appropriate the information to himself or another in breach of a confidence. It involves an obligation of fair dealing, implied from the very value of the information itself or created by express contract.[130] Unlike a patent, the owner has no right to prevent one who independently discovers such information from using it; the

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in *Kewanee* stated that one of the disadvantages that would result from denying trade secret protection would be *excessive* security measures. 416 U.S. at 486.

[125] 1969-2 C.B. at 302.

[126] Those few authorities stating the "absolute" view that a secret can be known only by the owner and employees with a need to know generally do so gratuitously. In other words, it is rare, if ever, that a court will employ the absolute secrecy doctrine as a rule of decision in a case. See R. MILGRIM § 2.07[2] at 2-75 to 2-76 & n. 11.

[127] *See also* the discussion of the Service's novelty requirement at text accompanying notes 155-159 *infra.*

[128] 416 U.S. at 481. Contrast rights in a trade secret which survive as long as the information remains secret. American Dirigold Corp. v. Dirigold Metals Corp., 125 F.2d 446 (6th Cir. 1942).

[129] Kewanee Oil Co. v. Bicron Corp. 416 U.S. 470, 478 (1974).

[130] In essence a trade secret action is one for "inequitable competition arising from a breach of trust." Vulcan Detinning Co. v. American Can Co., 72 N.J. Eq. 387, 67 A. 339, 343 (1907) (granting trade secret protection despite the fact that the secret had been stolen before). *See also* Nash, *The Concept of 'Property' in Know-how as a Growing Area of Industrial Property: Its Sale and Licensing,* 6 PAT. T.M. & COPYRIGHT J. OF RESEARCH & EDUC. 289 (1962).

owner's rights therefore are not exclusive.[131] The owner does, however, have the right to prevent another from appropriating information discovered and developed by the owner's efforts. Having expended time and money to make a discovery, the owner has the right to force competitors to make the same investment of their own time and money.[132] The owner retains his right until that point in time when the information becomes generally known.[133]

Since a trade secret action is essentially an action for misappropriation, a requirement of absolute secrecy is irrelevant in defining the trade secret right. The protective rights derive from the competitive value of the information. It does not matter if only the owner and a minimum number of employees know the secret. Rather what matters is whether knowledge of the secret is sufficiently limited so that one who does not know the information cannot equitably appropriate it from one who does know it.[134]

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[131] "A trade secret law, however, does not offer protection against discovery by free and honest means, such as by independent invention, accidental disclosure, or by so-called reverse engineering. . . ." Kewanee Oil Co. v. Bicron Corp., 416 U.S. 470, 476 (1974). Rather the holder of a trade secret is protected against someone acquiring the knowledge by "improper" means. *Id.* Thus the proprietary right under a trade secret is not an exclusive property right in the information, but rather the right to protect one's information from improper appropriation. RESTATEMENT OF TORTS § 757 at 4. Droeger v. Welsh Sporting Goods Corp., 541 F.2d 790, 792 (9th Cir. 1976); Frances H. Shepard, Jr., 57 T.C. 600, 614 (1972), *rev'd* 481 F.2d 1399 (3d Cir. 1973) *cert. denied,* 417 U.S. 911 (1974); Junker v. Plummer, 320 Mass. 101, 67 N.E.2d 667, 670 (1946).

[132] The *Kewanee* Court quoted language from the leading case of A.O. Smith Corp. v. Petroleum Iron Works Co., 73 F.2d 531, 539 (6th Cir. 1934), *modified* 74 F.2d 934 (1935) which noted the function of trade secret law to protect one who makes a discovery, even if nonpatentable, from the competitive injury resulting from a "competitor who by unfair means, or as the beneficiary of a broken faith, obtains the desired knowledge without himself paying the price in labor, money, or mechanics expended by the discoverer." 416 U.S. at 482. This statement repeats a view expressed by the Supreme Court some seventy years before: "The plaintiff has the right to keep the work which it has done, or paid for doing, to itself. The fact that others might do similar work, if they might, does not authorize them to steal the plaintiff's." Chicago Bd. of Trade v. Christie Grain & Stock Co., 198 U.S. 236, 250 (1905).

[133] As long as information is substantially secret it will support an action for misappropriation, *See* text accompanying note 139 *infra.* However, once information becomes a matter of general or public knowledge it cannot be a trade secret and any rights to protection are lost. RESTATEMENT OF TORTS § 757, at 5-6. 416 U.S. at 475.

[134] Kewanee Oil Co. v. Bicron Corp., 416 U.S. 470, 474 (1974). Servo Corp. of Am. v. General Elec. Co., 393 F.2d 551, 555 (4th Cir. 1968). "It is the employment of improper means to procure the trade secret, rather than the mere copying or use, which is the basis of the liability under the rule stated in this section." RESTATEMENT OF TORTS § 757 at 3-4. *See* E.I. DuPont de Nemours Powder Co. v. Masland, 244 U.S. 100, 102 (1917); E.I. DuPont de Nemours & Co. v. United States, 288 F.2d 904, 910 (Ct. Cl. 1961); International

Consequently the Restatement expresses the broader majority rule of relative secrecy:[135]

> It is not requisite that only the proprietor of the business know it. He may, without losing his protection, communicate it to employees involved in its use. He may likewise communicate it to others pledged to secrecy. Others may also know of it independently, as, for example when they have discovered the process and formula by independent invention and are keeping it secret.[136]

In other words, contrary to the Service's stance in Revenue Procedure 69-19, the mere fact that an owner has licensed his secret to others,[137] or that others have independently discovered the secret,[138] does not destroy the owner's proprietary interest in preventing unauthorized disclosure or use of his secret. All that is required is that "a substantial element of secrecy . . . exist, so that, except by the use of improper means, there would be difficulty in acquiring the information."[139]

Admittedly, certain disclosures will destroy the element of

Indus., Inc. v. Warren Petroleum Corp., 99 F. Supp. 907, 913 (D. Del. 1951) *aff'd* 248 F.2d 696 (3d Cir 1957), *appeal dismissed,* 355 U.S. 943 (1958); Allen Mfg. Co. v. Loika, 145 Conn. 509, 144 A.2d 306, 309 (1958).

[135] *See, e.g.,* Tri-Tron Int'l v. Velto, 525 F.2d 432, 436 (9th Cir. 1975); K-2 Ski Co. v. Head Ski Co., 506 F.2d 471, 473-74 (9th Cir. 1974); A.H. Emery Co. v. Marcan Products Co., 389 F.2d 11, 16 (2d Cir.), *cert. denied,* 393 U.S. 835 (1968); Republic Sys. & Programming, Inc. v. Computer Assistance, Inc., 322 F.Supp. 619 (D. Conn. 1970), *aff'd,* 440 F.2d 996 (2d Cir. 1971); Cudahy Co. v. American Labs. Inc., 313 F. Supp. 1339, 1343-44 (D. Neb. 1970); Plastic & Metal Fabricators, Inc. v. Roy, 163 Conn. 257, 303 A.2d 725 (1972); Town & Country House & Home Serv. Inc. v. Evans, 150 Conn. 314, 317-18, 189 A.2d 390, 393 (1963); Henkle & Joyce Hardware Co. v. Maco, Inc., 195 Neb. 565, 571, 239 N.W.2d 772, 776 (1976); R. MILGRIM, *supra* note 7, § 2.07[2].

[136] RESTATEMENT OF TORTS § 757, at 6.

[137] Kewánee Oil Co. v. Bicron Corp., 416 U.S. 470, 475 (1974); Chicago Bd. of Trade v. Christie Grain & Stock Co., 198 U.S. 236, 250-51 (1904).

[138] The mere fact that others have obtained the information does not defeat its status as a trade secret. Thus one early opinion states:

> A "secret" is nothing more than a private matter; something known only to one or a few and kept from others. It may be acquired by lawful means, . . . without tracing title to the originator, and when so acquired it does not necessarily cease to be a secret which may be protected from unlawful competition. Secrecy may be absolute or relative.

Kaumagraph Co. v. Stampagraph Co., 235 N.Y. 1, 138 N.E. 485, 487 (1923). *See* McKinzie v. Cline, 197 Or. 184, 252 P.2d 564, 567-68 (1953).

[139] K-2 Ski Co. v. Head Ski Co., 506 F.2d 471, 473-74 (9th Cir. 1974); A.H. Emery Co. v. Marcan Prods. Co., 389 F.2d 11, 16 (2d Cir.), *cert. denied,* 393 U.S. 835 (1968); Basic Chems. Inc. v. Benson, 251 N.W.2d 220, 229 (Ia. 1977); Space Aero Prods. Co. v. R.E. Darling Co., 238 Md. 93, 109-10, 208 A.2d 74, 82, *cert. denied,* 382 U.S. 843 (1965); Sun Dial Corp. v. Rideout, 16 N.J. 252, 257, 108 A.2d 442, 445 (1954).

substantial secrecy required by the Restatement. In some instances, the public distribution and sale of a product will eliminate any trade secret claimed in its design.[140] The publication of a patent will also destroy the required element of secrecy.[141] Similarly, publication in trade magazines or the general availability of the information may destroy the secret.[142]

However, disclosure in and of itself will not preclude protection of a trade secret unless that disclosure renders "meaningless" the duty to maintain such information in confidence.[143] At bottom, the issue is whether the information remains secret to the

[140] Koehring Co. v. E.D. Etnyre & Co., 254 F. Supp. 334, 361 (N.D. Ill. 1966); Houser v. Snap-On Tools Corp. 202 F. Supp. 181, 187 (D. Md. 1962); Speciner v. Reynolds Metal Co., 177 F. Supp. 291, 296 (S.D.N.Y. 1959), *aff'd*, 279 F.2d 337 (2d Cir. 1960); Bimbo Mfg. Co. v. Starz Cylinder Co., 119 Ill. App. 2d 251, 256 N.E.2d 357, 364 (1969). *See* Skoog v. McCray Refrigerator Co., 211 F.2d 254, 257 (7th Cir. 1954) (public display of innovation). But this result follows only when the claimed secret can be easily discovered from inspection of the product. Smith v. Dravo Corp., 203 F.2d 369, 374 (7th Cir. 1953). Thus, *Dravo* in finding a trade secret commented: "Here was no simple device, widely circulated, the construction of which was ascertainable at a glance." *Id.* at 375. *See* Kubik Inc. v. Hull, 56 Mich. App. 335, 224 N.W.2d 80, 93 (1974); K & G Tool & Service Co. v. G & G Fishing Magnets, Inc., 58 Tex. 594, 314 S.W.2d 782, 787, *cert. denied*, 358 U.S. 898 (1958).

[141] Once a patent is granted, all the details of the invention are published and secrecy is lost. Thus a trade secret action cannot be maintained for appropriations after that date. Scharmer v. Carrollton Mfg. Co., 525 F.2d 95, 99 (6th Cir. 1975). However, if the secret is appropriated before the patent is published, even though the patent is later published, most courts will nonetheless continue to recognize the trade secret action. *See, e.g.*, Engelhard Indus., Inc. v. Research Instrumental Corp., 324 F.2d 347, 352 (9th Cir. 1963), *cert. denied*, 377 U.S. 923 (1964); Shellmar Prods. Co. v. Allen-Qualley Co., 87 F.2d 104 (7th Cir. 1936), *cert. denied*, 301 U.S. 695 (1937); Julius Hyman & Co. v. Velsicol Corp., 123 Colo. 563, 233 P.2d 977 (1951); Adolph Gottscho, Inc. v. American Marking Corp., 18 N.J. 467, 114 A.2d 438 (1955); Hyde Corp. v. Huffines, 158 Tex. 566, 314 S.W.2d 763, *cert. denied*, 358 U.S. 898 (1958).

[142] Pressure Science Inc. v. Kramer, 413 F. Supp. 618, 626 (D. Conn. 1976), *aff'd*, 537 F.2d 301 (1977), aff'd 551 F.2d 301; Ferranti Electric Inc. v. Harwood, 43 Misc. 2d 533, 251 N.Y.S.2d 612 (1964). But the disclosure must destroy the value of the secret. Pressed Steel Car Co. v. Standard Steel Car Co., 210 Pa. 464, 60 A. 4, 9 (1904); A.H. Emery Co. v. Marcan Prods. Co., 388 F.2d 11, 16 (2d Cir. 1968). "Absolute secrecy is not essential and the plaintiff does not abandon his secret by delivering it or a copy to another for a restrictive purpose, nor by a limited publication." Plastic & Metal Fabricators, Inc. v. Roy, 163 Conn. 257, 303 A.2d 725, 731 (1972).

[143] Servo Corp. of America v. General Electric Corp., 393 F.2d 551, 555 (4th Cir. 1968); Wilkes v. Pioneer Am. Ins. Co., 383 F. Supp. 1135, 1140 (D.S.C. 1974).

> The fact that one secret can be discovered more easily than another does not affect the principle. Even if resort to the patterns of the plaintiff was more of a convenience than a necessity, still, if there was a secret, it belonged to him, and the defendant had no right to obtain it by unfair means, or to use it after it was thus obtained.

Tabor v. Hoffman, 118 N.Y. 30, 23 N.E. 12, 13 (1889).

extent that it retains a competitive value. Information may have been discovered by others, or disclosed to others; yet despite this "publication" the information may continue to provide the "possessor a commercial advantage over his competitors. This advantage constitutes value, and the disclosure of the information which creates the advantage may be sufficient to raise the implied agreement not to appropriate it."[144]

The possessor's competitive advantage derives principally from the effort that a competitor would have to expend in order to obtain the same knowledge.[145] Thus, in assessing the impact of disclosure on the viability of a secret, the proper question is not whether the disclosure makes the secret discoverable, but rather, whether an effort is still required in order to discover the secret. As a result, in evaluating a trade secret it is not determinative that one could develop or deduce the secret by examining published materials[146] or through one's own experimentation.[147] Nei-

[144] Kamin v. Kuhnau, 233 Or. 139, 374 P.2d 912, 917 (1962).

[145] "[T]he mere fact that [a means of] lawful acquisition is available does not mean that he may, through a breach of confidence, gain the information in usable form and escape the efforts of inspection and analysis." Smith v. Dravo Corp., 203 F.2d 369, 375 (7th Cir. 1953). Similarly, in holding that know-how reduced to blueprints constituted a trade secret, one court states: "To be secret means that a blueprint, for example, is not in the public domain through divulgence and that it is not too easily discoverable; that is, apparent to all without too much hard work." Schulenburg v. Signatrol, Inc., 50 Ill. App. 2d 402, 200 N.E.2d 615, 618 (1964). *See* Telex Corp. v. I.B.M. Corp., 367 F. Supp. 258 (N.D. Okla. 1973), *modified*, 510 F.2d 894 (10th Cir.), *cert. denied*, 423 U.S. 802 (1975); *see also* Imperial Chem. Indus., Ltd. v. National Distillers & Chem. Corp., 342 F.2d 737, 743 (2d Cir. 1965).

[146] "It matters not that defendants could have gained their knowledge from a study of the expired patent and plaintiffs' publicly marketed product. The fact is that they did not. Instead they gained it from plaintiffs via their confidential relationship and in so doing incurred a duty not to use it to plaintiffs' detriment." Franke v. Wiltschek, 209 F.2d 493, 495 (2d Cir. 1953).

In Ellicott Mach. Corp. v. Wiley Mfg. Corp., 297 F. Supp. 1044 (D. Md. 1969) the court found that a trade secret existed despite the fact that one could have discovered the secret "by expending a considerable amount of time in the inspection of Ellicott dredges and by searching catalogues and brochures issued over a period of years by various suppliers." Where a combination of information is not itself a matter of public knowledge, the fact that one can piece together the knowledge through the disclosed pieces does not destroy the trade secret. *Id.* at 1052-53. *See* note 145 *supra* and accompanying text; Franke v. Wiltschek, 209 F.2d 493, 495 (2d Cir. 1953).

[147] International Indus. v. Warren Petroleum Corp., 99 F. Supp. 907, 913 (D. Del. 1951), *aff'd*, 248 F.2d 696 (3d Cir. 1957), *appeal dismissed*, 355 U.S. 943 (1958); Minnesota Mining & Mfg. Co. v. Technical Tape Corp., 23 Misc. 2d 671, 192 N.Y.S.2d 102, 119 (1959); Schavior v. American Rebonded Leather Co., 104 Conn. 472, 133 A. 582, 583 (1926).

ther will the mere marketing of a product destroy the underlying trade secret if one must "reverse engineer" in order to discover that product.[148] Similarly, it is no defense in a misappropriation action to assert that "the information embraced in each secret could have been discovered by diligent research or could have been ascertained by restoring to sources which the defendant never explored, such as testimony in prior litigation or the examination of expired patents, or by resorting to an article in a trade magazine. . . ."[149] In other words, by affording protection to all information which provides a competitive advantage, the Restatement ignores the issue of who knows or could know the information. Rather, the crucial issue becomes who does not know the "secret." If enough people remain in ignorance so that the information retains competitive value the information will be protected, and therefore should represent property for taxing purposes.[150]

Even disregarding the impact of the Restatement, the 1961 Court of Claims decision, *E.I. DuPont de Nemours & Co. v. United States*,[151] should bind the Service to the relative secrecy doctrine. *DuPont* defined trade secret to include "any information not generally known in the trade . . . . The information is frequently in the public domain . . . . *A plurality of individual discoverers may have protectible, wholly separate rights in the same trade secret.*"[152] Having so established the breadth of the

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> By measuring the component parts, they say, blueprints could have been prepared and the most efficient productive method deduced. The fact remains, however, that the defendants took unwarranted advantage of the confidence which the Schreyers reposed in them and obtained the desired knowledge without the expenditure of money, effort and ingenuity which the experimental analysis of the model on the market would have required. Such an advantage obtained through breach of confidence is morally reprehensible and a proper subject for legal redress.

Schreyer v. Casco Prods. Corp., 97 F. Supp. 159, 168 (D. Conn.), *modified*, 190 F.2d 921 (2d Cir. 1951), *cert. denied*, 342 U.S. 913 (1962).

[148] *See* note 140 *supra;* R. MILGRIM, *supra* note 7, § 2.05[3]; Cavitch, *supra* note 7, § 232.01[5].

[149] Minnesota Mining & Mfg. Co. v. Technical Tape Corp., 23 Misc.2d 671, 192 N.Y.S.2d 102, 116 (1959).

[150] See the discussion of *Kewanee* at text accompanying notes 111-119 *supra*, and the discussion of relative secrecy at text accompanying notes 134-139 *supra*.

[151] E.I. DuPont de Nemours & Co. v. United States, 288 F.2d 904 (Ct. Cl. 1961).

[152] Id. at 911. In a similar case involving capital gains treatment of trade secrets, Francis H. Shepard, 57 T.C. 600, 617-18 (1972), *rev'd without opinion*, 481 F.2d 1399 (3d Cir. 1973), *cert. denied*, 417 U.S. 911 (1974), the court quoted extensively from *Tabor v.*

trade secret concept, *DuPont* concluded that trade secrets become property for purposes of the capital gains sections of the Code because, like patents, a trade secret affords its owner a "means to competitive advantage."[153] The court further noted, however, that with trade secrets, unlike patents, one's competitive advantage derives not from absolute rights but from one's right to prevent unauthorized disclosure of the secret;[154] thus, if the information is sufficiently secret to support a claim of misappropriation it will be property for the purposes of the Internal Revenue Code. This conclusion is in marked contrast to the Service's position that the secret can only be known by the employer and those employees with a need to know.

B. *Must the Information Be Unique, Novel and Original?*

The Service's requirement that the information be in the nature of an "invention" cannot withstand attack once the preeminence of the concept of competitive advantage is established. Again the Service fails to draw the distinction between the absolute rights of patents and the relative rights of trade secrets. Since a patent grants the owner an absolute monopoly and precludes ownership rights in others who may independently discover the invention, the invention must in fact be a clear advance in technology in order to warrant such an exclusive property interest.[155] Specifically, the invention must be original, unique, and novel.[156] However, since a trade secret constitutes something of value sufficient to support a claim of breach of confidence, inventiveness becomes a meaningless standard of assessment.[157] Rather, the correct approach is to determine if the information is an "advance" in technology sufficient to provide its owner with a competitive advantage.[158] If the discovery has such a competi-

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Hoffman, supra note 143, to support the conclusion that the disclosure must place the information in the public domain before one's secret (*i.e.* property) is destroyed.

[153] *Id.*; Stalker Corp. v. United States, 209 F. Supp. 30, 33 (E.D. Mich. 1962).

[154] 288 F.2d at 911-12; Stalker Corp. v. United States, 209 F. Supp. at 34. *See* Francis H. Shepard, Jr., 57 T.C. 600, 616-18 (1972), *rev'd without opinion* 481 F.2d 1399 (3d Cir. 1973), *cert. denied,* 417 U.S. 911 (1974).

[155] The requirements of novelty and invention "are essential to patentability because a patent protects against unlicensed use of the patented device or process even by one who discovers it properly through independent research." RESTATEMENT OF TORTS § 757 at 6-7.

[156] *See* 35 U.S.C. §§ 101-103 (1970).

[157] RESTATEMENT OF TORTS § 757 at 7.

[158] *See* text at note 119 *supra.*

tive value, then it must be a trade secret, and therefore should be property for purposes of section 351.[159]

The Service's test of invention, however, merely gives lip-service to this concept of trade secret. In Revenue Ruling 64-56 the Service states that the information need not be patentable.[160] In Revenue Procedure 69-19 the Service repeats this statement but nevertheless imposes a test of invention equivalent to that required for a patent: "[T]he 'information' [must] represent a discovery and, while not necessarily patentable, the 'information' [must be] original, unique, and novel."[161]

The additional requirement that the information be "original, unique, and novel" is totally contrary to the view espoused in the Restatement. The Restatement specifically states that the test of competitive advantage does not demand high standards of creativity. A trade secret need not be patentable;[162] novelty and invention are not required.[163] The information may be nothing more than something which is clearly anticipated in the prior art[164] or *"[information] which is merely a mechanical improvement that a good mechanic can make."*[165] Certainly,

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[159] As has been argued above, anything qualifying as a trade secret under the Restatement's definition must represent property, as required by *DuPont* and *Kewanee*. *See* text accompanying notes 111-119 *supra*. This conclusion is further reinforced by the earlier 1961 *DuPont* decision which broadly defines what may constitute a trade secret. *See* text accompanying notes 151-154 *supra*.

[160] Information need not be "patentable in the patent law sense." 1964-1 (Part 1) C.B. at 134.

[161] 1969-2 C.B. at 302.

[162] RESTATEMENT OF TORTS § 757, Comment b at 6.

[163] *Id. See, e.g.*, Kewanee Oil Co. v. Bicron Corp., 416 U.S. 470, 476 (1974); University Computing Co. v. Lykes-Youngstown Corp., 504 F.2d 518, 535 n.25 (5th Cir. 1974); Kodekey Elec., Inc. v. Mechanex Corp., 486 F.2d 449, 455 (10th Cir. 1973); Clark v. Bunker, 453 F.2d 1006, 1009 (9th Cir. 1972); Water Serv., Inc. v. Tesco Chem. Inc., 410 F.2d 163, 172-73 (5th Cir. 1969); Monolith Portland Midwest Co. v. Kaiser Alum. & Chem. Corp., 267 F. Supp. 726, 731 (S.D. Cal. 1967), *modified*, 407 F.2d 288 (9th Cir. 1969); Seismograph Serv. Corp. v. Offshore Raydist, 135 F. Supp. 342, 354 (E.D. La. 1955), *modified*, 263 F.2d 5 (5th Cir. 1958); Sun Dial Corp. v. Rideout, 16 N.J. 252, 108 A.2d 442 (1954); Henkle & Joyce Hardware Co. v. Maco Inc., 195 Neb. 565, 239 N.W.2d 772, 776 (1976); Extrin Foods v. Leighton, 202 Misc. 592, 115 N.Y.S.2d 429 (1952); R. MILGRIM, *supra* note 7, § 2.08[2] and authorities cited therein at n.9.

[164] *See, e.g.*, E.W. Bliss Co. v. Struther-Dunn, Inc., 291 F. Supp. 890 (S.D. Ia. 1968); Sperry Rand Corp. v. Rothlein, 241 F. Supp. 549, 560 (D. Conn. 1964) Sinclair v. Aquarius Elec., Inc., 42 Cal. App. 3d 216, 116 Cal. Rptr. 654, 659 (1974); Mann v. Tatge Chem. Co., 201 Kan. 326, 440 P.2d 640, 647 (1968); Gallowhur Chem. Corp. v. Schwerdle, 37 N.J. Supr. 385, 117 A.2d 416, 421 (1955); Fairchild Engine & Airplane Corp. v. Cox, 50 N.Y.S.2d 643, 656 (S.Ct. 1944); R. MILGRIM, *supra* note 7, at § 2.08[3].

[165] RESTATEMENT OF TORTS § 757 at 7. A.O. Smith Corp. v. Petroleum Iron Works, Co.,

there must be some element of "discovery" involved so that the information contains an element of secrecy and thus provides the owner with a competitive advantage.[166] But this liberal standard of discovery is all that is required.[167]

Consequently, if the information in fact provides its owner with a competitive advantage, it does not matter if the "discovery" may appear to be simple or obvious.[168]

> Facts of great value may, like the lost purse upon the highway, lie long unnoticed upon the public commons. Hundreds pass them by, till one more observant than the rest makes the discovery. It is idle

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73 F.2d 531, 539 (6th Cir.), *modified*, 74 F.2d 934 (1934); Ranger Steel Prods. Corp. v. Chodak, 128 N.Y.S.2d 607, 610 (S. Ct. 1953); Kamin v. Kuhnau, 233 Ore. 139, 374 P.2d 912, 917 (1962); R. MILGRIM, *supra* note 7, § 2.08[3] at 2-94. *See* Sloan v. Mud Prods., 114 F. Supp. 916, 924-27 (N.D. Okla. 1953).

[166] "[S]ome novelty will be required if merely because that which does not possess novelty is usually known; secrecy, in the context of trade secrets, thus implies at least minimal novelty." Kewanee Oil Co. v. Bicron Corp., 416 U.S. 470, 476 (1974). Hooker Chem. Corp. v. Velsicol Chem. Corp., 235 F. Supp. 412 (W.D. Tenn. 1964); Sarkes Tarzian, Inc. v. Audio Devices Inc., 166 F. Supp. 250, 265 (S.D. Cal. 1958) *aff'd per curiam*, 283 F.2d 695 (9th Cir. 1960), *cert. denied*, 365 U.S. 869 (1961).

[167] "Quite clearly discovery is something less than invention. Invention requires genius, imagination, inspiration, or whatever is the faculty that gives birth to the inventive concept. Discovery may be the result of industry, application, or be perhaps merely fortuitous. The discoverer, however, is entitled to the same protection as the inventor." A.O. Smith Corp. v. Petroleum Iron Works Co., 73 F.2d 531, 538 (6th Cir.), *modified*, 74 F.2d 934 (1934).

[168] The mere fact that the means by which a discovery is made are obvious, that experimentation which leads from known factors to an ascertainable but presently unknown result may be simple, we think cannot destroy the value of the discovery to one who makes it, or advantage the competitor who by unfair means, or as the beneficiary of a broken faith, obtains the desired knowledge without himself paying the price in labor, money, or machines expended by the discoverer.

A.O. Smith Corp. v. Petroleum Iron Works Co., 73 F.2d 531, 538-39 (6th Cir.), *modified*, 74 F.2d 934 (1934). *See* Franke v. Wiltschek, 209 F.2d 493, 499 (2d Cir. 1953); Forest Labs., Inc. v. Formulations, Inc., 299 F. Supp. 202, 208 (E.D. Wis. 1969), *modified*, 452 F.2d 621 (7th Cir. 1971); Mann v. Tatge Chem. Co., 201 Kan. 326, 440 P.2d 640, 647 (1968); Cavitch, *supra* note 7, § 232.01[6]; *see also* Cooper, *supra* note 46, at 335 (1966).

There are other variations to the same broad approach. For example, one court asks directly whether the discovery is simple and obvious in order to determine if the information provides a competitive advantage. K&G Oil Tool & Serv. Co. v. G&G Fishing Tool Serv., 158 Tex. 594, 314 S.W.2d 782, 790 (1958) (holding that a magnetic fishing tool represented a trade secret). California expresses a similarly broad standard: "[I]t has been held that a trade secret in the broad sense consists of any unpatented idea which may be used for industrial and commercial purposes." Sinclair v. Aquarius Elec., Inc., 42 Cal. App.3d 216, 116 Cal. Rptr. 654, 658 (1974) (holding that a portable device which converted brain waves into an audible signal was a mechanical improvement over existing stationary equipment and therefore was a trade secret.).

> to say that, in the eyes of the law, interest may not in such case follow discovery.[169]

The test of competitive advantage has been sometimes stated as "that modicum of originality which will separate it from everyday knowledge."[170] The broad concept of "modicum of originality" can hardly be compared with the Service's narrow demand that the information be original, unique, and novel.[171]

C. *Are Mere Experience and Mere Plant Design Property?*

Because the Service's "unique and novel" and "absolute secrecy" requirements fail to address the true property issue, the competitive value of the information, those factors which the Service has enumerated as guidelines for resolving these factual controversies also become meaningless standards. Among those items most concerning the Service in a section 351 know-how transfer,[172] the two most striking are mere knowledge or efficiency resulting from experience and information representing "assistance in the construction of a plant building . . . or advice as to the layout of plant machinery and equipment."[173] The Service will presume that these items constitute services.

Although admirably suited to the Service's design to expand the "services exclusion" under section 351 to its greatest possible breadth, these factors bear little relation to the Restatement's concern for competitive advantage. Certainly "mere" knowledge

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[169] A.O. Smith Corp. v. Petroleum Iron Works Co., 73 F.2d 531, 539 (6th Cir. 1934), *modified*, 74 F.2d 934 (1935).

[170] Cataphote Corp. v. Hudson, 444 F.2d 1313, 1315 (5th Cir. 1971), quoted in Forest Labs., Inc. v. Pillsbury Co., 452 F.2d 621, 624 (7th Cir. 1971). The test may be alternatively stated as that amount of "novelty" and "secrecy" necessary to make the knowledge commercially valuable. Atlantic Wool Combing Co. v. Norfolk Mills, Inc. 357 F.2d 866, 869 (1st Cir. 1966).

[171] The requirement "that the know-how 'represents a discovery and, while not necessarily patentable, the information is original, unique and novel,' is a serious deviation from trade secret law. Such a requirement imposes a standard of discovery which is not required by the courts, and which is contrary to controlling state common law under which trade secrets are recognized, as well as state court decisions governing trade secrets. *A more appropriate criteria for deciding whether 'property' has been transferred might be a determination of whether the conveyance of the know-how also conveys a competitive advantage on the transferee.*" J. BISCHEL, *supra* note 1, ¶ 6.3b[3], 6-23-6-24 (emphasis added). Nearly identical language can be found at R. MILGRIM, *supra* note 7, § 6.04[4] at 6-128.2.

[172] These factors are enumerated in Revenue Procedure 19, 1969-2 C.B. See note 182 *infra* for a discussion of those items not discussed in the text.

[173] Rev. Proc. 19, 1969-2 C.B. 302.

or efficiency resulting from experience can represent property within section 351 where that information amounts to a discovery, *i.e.* commercially valuable experience.[174] Perhaps the purest form of "mere experience" is a corporation's customer lists. In assessing whether such lists are trade secrets (and thus property), the courts have refused to impose requirements of novelty or absolute secrecy. Rather the courts examine such lists in terms of six factors set out in the Restatement, factors designed to assess whether the information provides a competitive advantage.[175]

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[174] Defendants contend that plaintiff's processes, methods and materials cannot be trade secrets, since they are known to and used by aircraft mechanics and engineers. This overlooks the fact that a *knowledge of the particular process, method or material which is most appropriate to achieve the desired result may itself be a trade secret.* So may a knowledge of the best combination of processes, methods, tools and materials.

Head Ski Co. v. Kam Ski Co., 158 F. Supp. 919, 923 (D. Md. 1958) (emphasis added). Space Aero Products Co., Inc. v. R.E. Darling Co., 238 Md. 93, 208 A.2d 74, 80, *cert. denied,* 382 U.S. 843 (1965). Thus, where experience is competitively valuable it will be given recognition as property: "The long experience of the plaintiffs enabled the defendant to efficiently equip its plant by the installation and use of several processes and devices, which although not patentable by the plaintiffs, yet were valuable additions to the equipment being installed." Reynolds Metals Co. v. Skinner, 166 F.2d 66, 75 (6th Cir.) *cert. denied,* 344 U.S. 858 (1948). *See also* B.F. Goodrich Co. v. Wohlgemuth, 117 Oh. App. 493, 192 N.E.2d 99 (1963).

[175] The Restatement specifically includes customer lists as potential trade secrets. § 757 at 5. The Restatement then enumerates the following factors to be considered in reviewing all potential trade secrets:

(1) the extent to which the information is known outside of his business; (2) the extent to which it is known by employees and others involved in his business; (3) the extent of measures taken by him to guard the secrecy of the information; (4) the value of the information to him and his competitors; (5) the amount of effort or money expended by him in developing the information; (6) the ease or difficulty with which the information could be properly acquired or duplicated by others.

RESTATEMENT § 757 at 6. Perhaps indicative of the difficult factual issues presented, the courts have been particularly willing to apply these factors to specifically consider whether customer lists will qualify as trade secrets. Republic Sys. & Programming, Inc. v. Computer Assistance, Inc., 322 F. Supp. 619, 628 (D. Conn. 1970), *aff'd,* 440 F.2d 996 (2d Cir. 1971); Cudahy Co. v. American Laboratories, Inc., 313 F. Supp. 1339, 1343 (D. Neb. 1970); Basic Chem., Inc. v. Benson, 251 N.W.2d 220, 226 (Ia. 1977); Jet Spray Cooler, Inc. v. Crampton, 361 Mass. 835, 282 N.E.2d 921, 925 (1972); Abbott Labs. v. Norse Chem. Corp., 33 Wisc.2d 445, 147 N.W.2d 529, 538-39 (1967).

It is noteworthy that the Restatement makes no reference to "mere experience"; rather, the factors recited above specifically assess the competitive value of the information. If "mere experience" satisfies the competitive advantage test, it will be protected as a trade secret. *See* Ashland Oil, Inc. v. F.T.C., 409 F. Supp. 297, 303 (D.D.C.), *aff'd,* 548 F.2d 977 (D.C. Cir. 1976), which applied the same six factors of the Restatement to rule

Thus, the courts will protect customer lists where substantial effort by a competitor would be required in order to duplicate the information.[175]

In fact, customer lists specifically illustrate the distorted construction of "property" which the Service advocates for section 351. For purposes of section 162[176] the Service readily maintains that customer lists represent "property" which must be capitalized rather than expensed in the year of purchase. The courts have unquestionably adopted the view that customer lists are property; the only issue is whether they are amortizable property under section 167[177] of the Code.[178] Since customer lists are "property," and since a customer list can be nothing but someone's accumulated "experience," how can the Service maintain

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that Ashland's gas reserves estimates were trade secrets for purposes of the federal Freedom of Information Act; United States v. Frazell, 335 F.2d 487, 490 (5th Cir. 1964), *cert. denied*, 380 U.S. 961 (1965), which ruled, without discussion, that oil maps were property for purposes of section 351.

[175] *See, e.g.*, Basic Chem., Inc. v. Benson, 251 N.W.2d 220, 229 (Ia. 1977); Heyman v. A.R. Winarick, Inc., 325 F.2d 584, 590 (2d Cir. 1963). *See also* the exhaustive discussion of customer lists in Annot., 28 A.L.R.3d 7 (1969).

Section 162(a) provides that "there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ." Treas. Reg. § 1.162-1 states in part that a business expense deduction will not be granted to the extent that an item "is used by the taxpayer in computing the cost of property included in its inventory or used in determining the gain or loss basis of its plant, equipment, or other property." Where an asset acquired for one's trade or business has a useful life in excess of one year, it is generally deductible under section 162. *See, e.g.*, Manhattan Co. of Va., 50 T.C. 78, 86 (1968); Richard M. Boe, 35 T.C. 720, 725 (1961), *aff'd*, 307 F.2d 339 (9th Cir. 1962).

[177] Section 167 states the rules concerning the depreciation deduction allowable for property used in a trade or business, or property held for the production of income. Treas. Reg. § 1.167(a)-3 provides that an intangible asset can be depreciated where it has a limited useful life "which can be estimated with reasonable accuracy." Notably, the most "intangible" of assets, goodwill, although not depreciable due to its indefinite life, is nonetheless considered "property" within the meaning of section 167. Treas. Reg. 1.167(a)-3; *see, e.g.*, Comm'r v. Killian, 314 F.2d 852 (5th Cir. 1963); Robert B. Tomlinson, 58 T.C. 570 (1972);Edward A. Kenney, 37 T.C. 1161 (1962).

[178] The following commercial lists were granted property status for the purpose of section 167: a list of fuel oil customers, Sunset Fuel Co. v. United States, 519 F.2d 781 (9th Cir. 1975) and Holden Fuel Oil Co., 31 T.C.M. (CCH) 184 (1972); newspaper subscription lists, Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240 (5th Cir. 1973); cable television customer lists, General Tele., Inc. v. United States, 77-2 U.S.T.C. (CCH) ¶ 9688 (D. Minn. 1977); laundry service customer lists, National Serv. Indus., Inc. v. United States, 379 F. Supp. 831 (N.D. Ga. 1973) and Manhattan Co. of Va., 50 T.C. 78 (1968); credit information files, Computing & Software, Inc., 64 T.C. 223 (1975); and a pharmacy prescription file, Grant T. Rudie, Jr., 49 T.C. 131 (1967).

that something which is "mere experience" is presumptively not property?

In the same fashion, advice as to plant construction or the lay out of machinery may also represent property where such advice concerns knowledge not in the public domain, knowledge that will afford the transferee an advantage over competitors who lack the benefit of such advice. Certainly the design of a manufacturing process, in some instances necessarily including plant design and the lay-out of machinery, qualifies as a trade secret where the discovery test is met.[179] Even the most abstract forms of production designs, or lay-outs, such as marketing techniques[180] or computer programs,[181] are granted trade secret protec-

[179] It is also of no consequence that the elements of the process or design are all of public knowledge. "[A] trade secret can exist in a combination of characteristics and components, each of which, by itself, is in the public domain, but the unified process, design and operation of which, in unique combination, affords a competitive advantage and is a protectable secret." Imperial Chem. Indus. Ltd. v. National Distillers & Chem. Corp., 342 F.2d 737, 742 (2d Cir. 1965). In other words, this combination of known processes will be a trade secret "if the combination of the interrelated parts represented a valuable contribution arising from plaintiff's independent efforts." Ferroline Corp. v. General Aniline & Film Corp., 207 F.2d 912, 921 (7th Cir. 1953) *cert. denied*, 347 U.S. 953 (1954). *See, e.g.*, Head Ski Co. v. Kam Ski Co., 158 F. Supp. 919, 923 (D. Md. 1958); Space Aero Prods. Co., Inc. v. R.E. Darling Co., 238 Md. 93, 208 A.2d 74, 80 (1965); Cavitch, *supra* note 7, § 232.01[3]. *See also* Eastern Marble Prods. Corp. v. Roman Marble, Inc. 364 N.E.2d 799 (Mass. 1977).

[180] For example, in Clark v. Bunker, 453 F.2d 1006 (9th Cir. 1972) plaintiff developed a marketing scheme for prepaid funeral services plans. Defendant alleged that he could not have misappropriated the scheme as it was not a trade secret. In the first instance the scheme was to a great degree based on elements of other marketing programs already of public knowledge. And secondly, the scheme had been sold to or discussed with a number of others in the mortuary business and therefore was no longer secret.

The court rejected both arguments. Even though the plan was not unique and novel the district court had found that the plan afforded plaintiff a marked advantage over competitors, and was therefore a trade secret. Similarly, the disclosures of the plan did not defeat its status as a trade secret since "[s]ubstantial effort would be required to assemble the detailed elements of the plan from publicly available sources." *Id.* at 1010.

The court in Wilkes v. Pioneer Am. Ins. Co., 383 F. Supp. 1135 (D.S.C. 1974), granted similar trade secret protection to a scheme for marketing life insurance. The court commented: "The forms and plans consisted of a combination of many commonly used practices, but were combined in a way that had not been used before, and gave plaintiff a marked advantage over competitors." *Id.* at 1139. Thus where a business design provides a competitive advantage, that design will be a trade secret and thus property for purposes of section 351.

Equally applicable to "mere efficiencies" and "advice as to plant construction," the Restatement broadly recognizes any commercial practice as potentially a trade secret. Thus a trade secret may "relate to the sale of goods or to other operations in the business, such as a code for determining discounts, rebates or other concessions in a price list or tion where substantial effort would be required to duplicate the information. Since these items receive trade secret protection, they should also represent property for the purposes of section 351 as well. Once again the key test is not whether the transfer takes on the appearance of a service, but rather whether the knowledge transferred supplies the transferee with a competitive advantage over those who do not possess the knowledge.[182]

catalogue, or a list of specialized customers, or a method of bookkeeping or other office management." § 757(b) at 5.

[181] In Rev. Proc. 36, 1974-2 C.B. 491, the Service cast a shadow on computer programs as property under section 351 when it stated that computer software would be judged as property according to the onerous conditions enumerated in Revenue Procedure 69-19. *See* Flyer & Buell, *supra* note 4, at 27-29 for an argument that computer software would likely not qualify as property if the Service applied a narrow definition to Revenue Ruling 64-56.

Although there is little direct authority on point, it seems evident that the same test of competitive advantage will also apply to computer software in determining if an element of "property" exists in the program. *See* Bender, *Trade Secret Protection of Software,* 38 GEO. WASH. L. REV. 909 (1970). In Structural Dynamics Research Corp. v. Engineering Mechanics Research Corp., 401 F. Supp. 1102 (E.D. Mich. 1975), the court avoided the specific issue of whether a computer program was a trade secret by finding that there was no misappropriation in that defendants themselves had developed the program. The court, nonetheless, held defendants liable for breaching their express contract not to disclose confidential information:

> The technical planning and development of NIESA [the program] to its stage of development in January, 1973, including the selection of elements, solver routine, organization of sub-routines, coding, and other factors contributing to the efficiency and effectiveness of the program constituted important and confidential information, particularly prior to public release of the program. The technical accomplishments of Surana and Kothwala reflected in their work on NIESA *amounted to a compilation of information which gave SDRC a competitive advantage. The existence or availability of abstract technical data does not detract from the confidentiality of the combination of such parts and data into a program of the type under consideration.*

Id. at 1116 (emphasis added).

In University Computing Co. v. Lykes-Youngstown Corp., 504 F.2d 518 (5th Cir. 1974) the misappropriation involved a retail inventory control system consisting of both computer hardware and software. Unfortunately the court made little effort to distinguish between the hardware and the software, instead addressing the computer "system." Nonetheless, it appears that the misappropriation at issue was predominantly, if not entirely, a theft of the software. *Id.* at 529 & n.6. Relying on the Restatement, the court stated that novelty was not required. Thus the system was a trade secret since it "had unique capabilities and features which make it a valuable competitive product." *Id.* at 535.

For an analysis of the reasons for granting patent protection to computer software, *see, e.g.,* Note, *Patentability of Computer Software: The Nonobviousness Issue,* 62 IOWA L. REV. 615 (1976).

[182] The Service also presumes that the following will not qualify as section 351 property:

D. *Is the "Incident to" Test the Restatement in Disguise?*

Even the Restatement may define property for section 351 purposes too narrowly. The court in *DuPont* stated the test as whether the transfer would confer a benefit, whether the information constitutes a positive business asset;[183] *Stafford* defined prop-

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(1) Training of the transferee's employees which is essentially educational in nature. Like the Service's distaste for mere knowledge or efficiency resulting from experience, the proper question is not whether the knowledge resulted from experience or whether the knowledge is training of employees; rather, the Service must ask if the knowledge provides the transferee a competitive advantage. If the knowledge is of such value then it must be property regardless of whether it was conveyed in the form of "training." *See* text accompanying notes 111-119 *supra*.

(2) Future transfers of information, such as new developments, and (3) information developed especially for the transferee. Both of these prohibitions appear to be carryovers from concepts peculiar to the capital gains sections. To qualify for capital asset status, the property must be held by the taxpayer for the prescribed period and cannot constitute property held "primarily for sale to customers in the ordinary course of his trade or business . . . ." I.R.C. § 1221. Thus transfers of property to be created, or property developed for the purpose of sale, would apparently not represent a "capital asset." *But see* text accompanying notes 103-104 *supra*.

Section 351, however, requires only that "property" be transferred; 351 contains no requirements that property must also qualify as a "capital asset." The *DuPont* decision discussed in the text accompanying notes 226-230 *infra* expressly rejected this analogy between section 1221 capital asset and section 351 property. Consequently, future transfers of information developed specifically for the transferee must also qualify as property for section 351, at least where that information meets the Restatement test of competitive advantage.

(4) Information which is merely "the rights to tangible evidence of information such as blueprints, drawings or other physical material on which it is recorded." If the Service, by this statement, is requiring that the transferor convey the knowledge to implement the plans along with the plans themselves in order for the transfer to qualify as a property transfer, the Service's position apparently contradicts its statements that mere experience and mere training cannot constitute property. If the Service is stating that blueprints and drawings are not property, the Service has adopted a position directly contrary to unquestioned authority indicating that quite often blueprints and drawings are protected trade secrets. *See, e.g.*, Smith v. Dravo Corp., 203 F.2d 369 (7th Cir. 1953); Tabor v. Hoffman, 118 N.Y. 30, 23 N.E. 12 (1889); R. MILGRIM, *supra* note 7, § 2.09[6] and authorities cited therein.

(5) Finally, the Service presumptively denies property status to information which is revealed by a patent, is the subject of a patent application, or is disclosed by the product on which it is used or to which it is related. It is true that there can be no trade secret in information which is revealed in a patent. However, while the information remains in the form of a patent application trade secret protection is granted where the competitive advantage test is met. R. MILGRIM, *supra* note 7, § 2.06[2], at 2-61 and authorities cited at n.20; text accompanying notes 1-47 & 51 *supra*. The Service's statement that the information cannot be disclosed by the product states the obvious. However, in applying this rule one must recall that disclosure is judged by the permissive concept of competitive advantage, not the more stringent requirements of absolute secrecy. *See* text accompanying note 148 *supra*.

[183] *See* text accompanying notes 34-37 *supra*.

erty in terms of what could be possessed, used, or transferred.[184] In 1955 even the Service apparently adopted this broad view. After stating that know-how is a right akin to secret processes and secret formulas, the Service defined know-how as "something that its possessor can grant to another for consideration."[185] Similarly, some courts assess the factual issue of competitive advantage by examining whether the information has value on the open market, i.e., whether the information is a positive business asset.[186] Know-how which represents a "business asset," or know-how which can be "transferred for consideration" may be but two different expressions of the same test of competitive advantage. All that should matter for tax purposes, however, is that the potentially broader concept of business asset is the standard applicable in transfers of know-how under section 351.

In practical effect, the "business asset" and "transferred for consideration" tests have been what the courts have in fact been using with respect to know-how transfers under section 351. Rather than expressly adopting these broad definitions of property for know-how purposes, the courts have found it easier to expand the Service's interpretation of the "ancillary and subsidiary to" exception, applying broader "incident to" language. However, the standard employed for defining "incident to" is the same business value concept endorsed by *DuPont* and recognized by the Restatement.[187]

For example, *Mineral Products Co.* recognized written instructions concerning the use of formulas, processes, and procedures, consulting services, and future communications as to developments in the field as property under the "incident to" excep-

[184] *See* text accompanying note 39 *supra*.

[185] Rev. Rul. 17, 1955-1 C.B. 389. This ruling, however, was not issued for the purposes of defining property for section 351, but rather to make the distinction between property and services for the purpose of determining royalty income. A similarly broad definition of intangible property is advocated by the Service in Regulation 1.482-2(d)(3) quoted in note 43 *supra*.

[186] "The difficulty of securing the necessary details except by unlawful means is evidenced by the substantial sum ($55,000) paid to appellee for a corporation which appellee had formed to use the plan . . . ." Clark v. Bunker, 453 F.2d 1006, 1010 (9th Cir. 1972). *See, e.g.*, Extrin Foods v. Leighton, 202 Misc.2d 592, 115 N.Y.S.2d 429, 435 (1952).

[187] One author has already noted that use of a broad definition of know-how as property would eliminate the need for the "ancillary and subsidiary" rule. *Cooper*, *supra* note 46, at 335.

tion. Specifications, quality-control procedures, and test data were necessary for the effective utilization of the transferred formulas, and were, therefore, implicitly business assets. Other information concerning sales, cost estimating, and application techniques was also designated as property. In language strongly reminiscent of a court applying the Restatement, the Tax Court noted: "Even though much of the material was available to competitors, it constituted valuable marketing information, developed through practice, which was oriented toward the particular properties of the CAFCO products and which could be obtained from no other source."[188]

Additionally, in *Bell*, production know-how, including engineering and manufacturing data, was granted property status because they were "incident to" the patents. The court noted, however, that the know-how conveyed "did not depend upon reference to the patent drawings[189] and was thus somewhat independent of the patents. Apparently, what justified the treatment of this know-how as property was not so much the integral relationship between the know-how and the patents as it was the unquestioned competitive value of the know-how transferred.[190]

Finally, *Gable* expressly minimizes the distinction between patents and know-how. The *Gable* court stated that the "incident to" exception was but "the recognition that a patent transfer is, in large part, a transfer of knowledge."[191] Know-how that "relates to" the patents transferred, *i.e.* know-how that assists the buyer "in implementing the acquired knowledge and in developing its full potential," may be just as valuable as the patents themselves.[192] *Gable* implies that know-how "related to" the transfer

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[188] 52 T.C. at 199. The court also found that the design of a device used to measure the bulk density of fibers was a capital asset as the evidence indicated "that it was not known to the trade." The parties to the contract transferring the asset had labelled the device as know-how. *Id.* at 198.

[189] 381 F.2d at 1020.

[190] "By virtue of the agreement with Bell, Agusta received the benefit of the FAA certification and obtained engineering know-how . . . which enabled it to build a small replica of the Bell Fort Worth plant and to enter into the helicopter business without the years of research and development and the expenditure of the millions of dollars which Bell had been required to spend in order to develop this over-all helicopter know-how."

Id.

[191] 33 T.C.M. (CCH) at 1433.

[192] *Id.*

of proprietary information constitutes property, even though it strongly resembles services.[193] Viewed in this fashion, the "incident to" exception is little more than the business asset test adapted to the specific context of transfers of packages of technology.

E. *Does The Broad Concept of Property Permit the Taxpayer a Choice of Law?*

As noted in the historical analysis of section 351 above, there has never been any question as to whether know-how will qualify as property. Rather, the issue left unresolved is *what forms* of know-how will qualify as property. In initial attempts to resolve this issue, the courts and the Service have taken divergent paths. Opinions analyzing section 351 indicate that the term "property" is to be given its broadest construction. Similarly, courts discussing know-how as property under sections 1231 and 1235 reveal that the "services exclusion" is to be applied to know-how sparingly, if at all. The Service, however, persists in expanding the concept of "services" to its maximum limits, while narrowly defining what forms of know-how qualify as property. Because of the broad definition given property under the decisions in *DuPont* and *Stafford*, the Service's position must yield to the more lenient standards of the Restatement, a definition of property endorsed by the Supreme Court in *Kewanee* and implicitly recognized by courts applying the "incident to" exception for services.

However, as also noted above, *DuPont* and *Stafford* may stand for a broader concept of property than that expressed by the Restatement. This conclusion is of particular importance with respect to international transfers where the taxpayer faces the additional issue of whose law of competitive advantage will determine whether a particular form of know-how will be granted property status. Revenue Ruling 64-56 states that the information must be given substantial protection in the country in which the transferee is to operate.[194] Revenue Procedure 69-19 incorporates

[193] Thus the court granted capital asset status to transfers of future know-how as well, based upon the value of this information in assisting the complete use of the patents transferred. These future transfers were so related to the underlying patent rights that even though not yet in existence, they would be granted capital asset status in defiance of the requisite holding period. *Id.* at 1433-34. For a similar result, see Heil Co. 38 T.C. 989, 1003 (1962) discussed at text accompanying notes 73-78 *supra*, and PPG Industries, 55 T.C. 928, 1018 (1970) discussed at text accompanying notes 89-91 *supra*.

[194] Rev. Rul. 56, 1964-1 (Part I) C.B. 133.

by reference the rules expressed in Revenue Ruling 64-56, and expressly repeats the requirement that the information be substantially protected in the country in which it is to be used. However, in a somewhat contradictory fashion, the Procedure later requires that the information be property within the meaning of Revenue Ruling 64-56 *and* that it be protected under the laws of the country *from* which it is being transferred.[195] To comply with the United States law, the information must meet the absolute secrecy and "unique and novel" tests already discussed. The Procedure then concludes that if these requirements are met, the information will be deemed to be protected under the laws of the transferee country as well, for the purposes of satisfying the advance ruling requirement of section 367. Significantly, the Service does not state whether this assumption is rebuttable, that is, whether the Service can later challenge a transfer under section 351 as not being protected under the law of the transferee country, even though the requirements for a pre-transfer 367 ruling have been met. Although the change under section 367 to post-transfer rather than pre-transfer rulings implemented by the Tax Reform Act of 1976 may eventually eliminate this ambiguity by eliminating the need for pre-transfer evaluation, at present the Service's statements indicate a willingness to evaluate "property" under the laws of *both* the transferor and transferee countries.[196]

Such fence-straddling by the Service ignores the courts' broad definition of property. If any person is to be permitted a "choice of law," it should be the taxpayer not the Service. The Service is justified in relying on United States law where the law of the transferee country is in substantial doubt or has yet to develop.[197] Nonetheless, in applying transferor country law the

[195] Rev. Proc. 19, 1969-2 C.B. 302.

[196] Rev. Proc. 69-19 concludes by stating that "these procedures have no effect upon the substantive provisions and requirements of Revenue Ruling 64-56." 1969-2 C.B. at 302. *But see* Flyer & Buell, *supra* note 4, for an argument that satisfying Revenue Procedure 69-19 necessarily satisfies the "protection under the laws of the transferee" requirement of Revenue Ruling 64-56.

[197] Illustrative of the potential uncertainties of foreign law regarding know-how in even the most highly developed countries see the discussion in A. WISE, TRADE SECRETS AND KNOW-HOW THROUGHOUT THE WORLD (1974), Vol. 1, § 1.04[1] (Belgium) (1976); Vol. 3, § 3.06 (France) (1974); Vol. 3, § 4.02[4] (Germany) (1974); Vol. 4, § 5.01[3] (Italy) (1974).

Because foreign law can create confusion, one might do better to address whether the

Service should employ the proper interpretation of that law, *i.e.* the liberal standards of the Restatement. Know-how which meets the Restatement's competitive advantage test will be protected in the United States, at least in Restatement jurisdictions. Therefore that information must represent "property" within the broad business asset concept expressed in *DuPont.* Taken one step further, since *DuPont* defines property only in terms of "positive business assets," not in terms of "protected business assets," once the Restatement has been satisfied, the information need no longer be judged against the protection rules employed by the transferee country. A recognized "asset" has been transferred, even though that asset may not qualify as protected property under stricter rules of foreign jurisdictions.

Conversely, what if a transferee nation employs broader rules than those expressed in the Restatement?[198] Will the taxpayer be permitted to employ this broader definition of property? If the transferee can protect his information in his country of business, it becomes irrelevant under the business asset test whether that information was also protected in the United States. If the transferee can protect the information, then clearly a valuable asset was transferred; the transferee has received a right capable of ownership, use, or disposition and, therefore, has received property under the definition expressed in *Stafford.* Indeed, if one law is to govern to the exclusion of the other, logic dictates that the law of the transferee nation control.[199] *DuPont* and *Stafford* pre-

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information would be recognized as capable of supporting a contract for royalties, rather than whether the information is property in and of itself. For example, although in France the property law of information is in doubt, Wise's summary of one French case addressing the royalty issue yields the very Restatement definition employed in the United States:

> By providing an industrial establishment with processes or techniques unknown to it, and which it could learn only through a considerable outlay of research and development expenditure and after the lapse of some time and effort, the licensor has provided the licensee with an appreciable advantage for which it may exact a royalty. This is so even if the particular process or technique is not secret.

3 A. WISE, *supra,* § 3.06[4], at 3-76 to 3-77 (1974).

[198] As a possible example of a standard broader than the Restatement, see 1 A. Wise, *supra* note 197, § 4.02[2] (1976), indicating that certain "technical skill" will receive property protection in the Republic.

[199] Because, in the case of transfer of the right to use a secret formula or process in a foreign country, the laws of the foreign country are determinative of the nature of the right being transferred, reference to the laws of the country of the transferor would seem to be inappropriate.

Flyer & Buell, *supra* note 4, at 27.

clude the Service from applying the laws of both the transferee and transferor nations.

III. WHAT CONSTITUTES A TRANSFER FOR PURPOSES OF SECTION 351?

As demonstrated above, the broad definitions of property expressed by the courts in such rulings as *DuPont, Stafford,* and *Hempt Bros.* obligate the Service to apply equally broad standards in analyzing the specific question of what forms of know-how will qualify as property under section 351. However, to focus exclusively on the property question is to ignore the equally important issue of what constitutes a qualifying "transfer" under the statute.[200] "Transfer" poses the question of what rights the transferor may retain in the property, yet still have the conveyance of the property deemed a transfer within the nonrecognition rules of section 351. One might expect that the lenient definition of property, particularly as analyzed in *DuPont,* would generate equally permissive standards regarding the kinds of transactions that will qualify as "transfers." Nonetheless, the Service has characteristically attempted to limit "transfer" to its strictest, most limited meaning. Relying almost exclusively on the judicial developments in the area of patent transfers for purposes of capital gains treatment under sections 1221, 1222, and especially

[200] *See* note 1 and accompanying text *supra*. Both the words "transfer" and "exchange" appear in section 351; however, the operative word is "transfer." Discussions have emphasized that for purposes of section 351 bona fide "sales" do not qualify as "transfers . . . in exchange". *See, e.g.*, Stanley, Inc. v. Schuster, 295 F. Supp. 812, 815 (S.D. Ohio 1969), *aff'd*, 421 F.2d 1360 (6th Cir.), *cert. denied*, 400 U.S. 822 (1970). Although the precise scope of the word "transfer" has been repeatedly addressed, many commentators have simply abided by the Service's restrictive rulings without questioning their validity. For a general discussion of the word "transfer" for purposes of know-how transfers under section 351, see BISCHEL, (no definition of what constitutes a transfer of all substantial rights) *supra* note 1, at ¶ 6.3; CALIFORNIA CONTINUING LEGAL EDUCATION, ATTORNEYS GUIDE TO TRADE SECRETS Ch. 6 (Brosnahan ed. 1971) (must transfer at least the right to prevent unauthorized disclosure); MILGRIM, *supra* note 7, at § 6.04 (discussion of the 1971 *DuPont* holding). *See also* Benjamin, *supra* note 44, at 200-01 (transfers of know-how under section 351 governed by § 1235); Burke, *supra* note 20, at 756-57 (Rev. Rul. 69-156 comports with legislative intent); Cohen, *supra* note 4, at 39-40 (Service's transfer requirements are highly questionable); Cooper, *supra* note 46, at 335-38 (discussion of the 1961 *DuPont* decision); Cooper, *supra* note 23, at 225-237 (discussion of transfer concept); Creed & Bangs, *supra* note 23, at 101-02, (discussion of all substantial rights test); Dunn, *supra* note 4, at 573-75 (discussion of the exclusivity element); Flyer & Buell, *supra* note 4, at 30 (discussion of the exchange requirement); Pugh, *Sales and Exchanges of Foreign Patents*, 20 N.Y.U. INST. FED. TAX 1305 (1962); Note, *supra* note 33, at 69 (Service's sale or exchange requirement is not supported by the Code).

1235, the Service has formulated tough guidelines as to how one may transfer know-how for purposes of section 351.[201] Briefly stated, only the unqualified transfer in perpetuity of the exclusive right to make, use, and sell unpatented but secret products

[201] I.R.C. § 1235 states: "A transfer (other than by gift, inheritance, or devise . . . of all substantial rights to a patent . . . shall be considered the sale or exchange of a capital asset . . . ." A strong argument may be made that it is only because of the presence of the "all substantial rights" language of section 1235 and the characterization of this provision as one of the capital gains provisions that limitation on the word "transfer" arises. Section 351 contains neither of these limitations. Nevertheless, the Service has been extremely successful in arguing that know-how should be treated similarly to the § 1235 treatment of patents. *See* PPG Indus., Inc., 55 T.C. 928, 1012 (1970); Edward W. Reid, 50 T.C. 33, 40-41 (1968); Pickren v. United States, 378 F.2d 595, 599 (5th Cir. 1967); Commercial Solvents Corp., 42 T.C. 455, 467-69 (1964); Kimble Glass Co., 9 T.C. 183, 190-91 (1947); E.I. DuPont de Nemours & Co. v. United States, 296 F. Supp. 823, 833-34 (D. Del. 1969), *modified*, 432 F.2d 1052 (3d Cir. 1970); Stalker Corp. v. United States, 209 F. Supp. 30, 33 (E.D. Mich. 1962).

An extensive body of law has developed regarding the elements necessary for a patent transfer to qualify for capital gains treatment under section 1235. The debate has raged primarily around the meaning of two phrases, "transfer" and "all substantial rights." For a discussion of the development that only "sales" and not mere "licenses" are required to qualify for section 1235 treatment, see Waterman v. MacKenzie, 138 U.S. 252, 255-58 (1890) (transfer must amount to an assignment not a mere license); E.I. DuPont de Nemours & Co. v. United States, 432 F.2d 1052, 1053-57 (3d Cir. 1970) (transfer of anything less than all substantial rights is a mere license); Redler Conveyor Co. v. Comm'r, 303 F.2d 567, 568-69 (1st Cir. 1962) (citing the *Waterman* test); Carroll Pressure Roller Corp., 28 T.C. 1288 (1957); Halsey W. Taylor, 16 T.C. 376, 381-84 (1951) (transfer of entire interest constitutes a sale not a mere license); American Chem. Paint Co. v. Smith, 131 F. Supp. 734, 737-39 (E.D. Pa. 1955) (preservation of substantial limitations by transferor deemed this is a mere license); Thompson v. Johnson, 50-2 U.S. Tax. Cas., ¶ 9428, 13127-30 (S.D.N.Y. 1950) (citing the *Waterman* test). For a discussion of the "all substantial rights" test, see William W. Taylor, 29 T.C.M. (CCH) 1488, 1492-96 (1970) (must transfer the exclusive right to manufacture, use and sell); Jacques R. Milberg, 52 T.C. 315, 317-20 (1969) (mere license because transferor retained use after license terminated); Allied Chem. Corp. v. United States, 370 F.2d 697, 699-700 (2d Cir. 1967) (enough control retained by transferor to preclude transfer from being a sale); Young v. Comm'r, 269 F.2d 89, 91-94 (2d Cir. 1959) (right to terminate at will destroyed by sale treatment); Buckley v. Frank, 57-1 U.S. Tax Cas. ¶ 9525, 57055-61 (W.D. Wash. 1957). For a detailed discussion of the overall developments in the field of section 1235 transfers of patents see Campbell, *supra* note 21, at 32-42; Cooper, *supra* note 46, at 334-38; Cooper, *supra* note 23, at 213-37; Morreale, *Patents, Know-How and Trademarks: A Tax Overview*, 29 TAX LAW. 553 (1976); Pugh, *supra* note 200; Ramunno, *U.S. Tax Aspects of International Licensing Agreements*, 5 DEN. J. INT'L L. & POL'Y 113 (1975).

The following rights have been held to be substantial: (1) right to terminate (Lynn Gregg, 18 T.C. 291, 302 (1952), *aff'd* 203 F.2d 954 (3d Cir. 1953)); (2) geographical limitations (Don Keuneman, 68 T.C. 609 (1977)); (3) terms for years (Treas. Reg. § 1.1235-2(b)(iii)); (4) field of use restrictions (David R. Blake, 67 T.C. 7, 13-16 (1976)). In contrast, retention of the following rights has been held to be insubstantial: (1) legal title as security (Treas. Reg. § 1.1235-2(b)(2)(i)); (2) provision for forfeiture for nonperformance (Treas. Reg. § 1.235-2(b)(2)(ii)); (3) oftentimes, the absolute right to prohibit sublicensing (Treas. Reg. § 1.1235-2(b)(3)(i)).

within all the territory of a country will be treated as the transfer of all substantial rights in the property in that country.[202]

The "all substantial rights" requirement carried over from patent transfer cases under the capital gains provision, section 1235, to know-how transfers under section 351(a) has been fleshed out by Regulation § 1.1235-2(b) which defines the phrase as *not* including a grant of rights (1) which is limited geographically within the country of issuance; (2) which is limited in duration by the terms of the agreement to a period less than the remaining life of the patent; (3) which grants rights to the grantee in fields of use within trades or industries, which are less than all the rights covered by the patent, which exist and have value at the time of the grant; and (4) which grants to the grantee less than all the claims or inventions covered by the patent which exist and have value at the time of the grant.[203] In recent years, the courts have upheld the validity of all four of these subsections with regard to patent transfers pursuant to section 1235.[204] In attempts to implement the statutory scheme of section 1235, as interpreted in the regulations promulgated thereunder, the courts, in *Fawick*

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[202] Rev. Rul. 1956, 64-1 C.B. 133, 135. The Service also stated in the ruling: "The unqualified transfer in perpetuity of the exclusive right to use a secret process or other similar secret information qualifying as property within all the territory of a country . . ." will be treated as a transfer of all substantial rights." *Id.* Rev. Rul. 64-56 was amplified in Rev. Rul. 564, 1971-2 C.B. 179 where the Service ruled that in order for all substantial rights in a trade secret to be transfered, the transferor must transfer to the transferee the use of the trade secret for its full life. For a general discussion of the Service's position see 70-20 TAX MANAGEMENT MEMORANDUM, *supra* note 66, at 6-15.

[203] Treas. Reg. § 1.1235-2(b) (1965). The present section 2(b) of the regulation was not adopted until 1965, one year after Rev. Rul. 56, 1964-1 C.B. 133. *See* T.D. 6852, 1965-2 C.B. 289.

[204] *See* Don Keuneman, 68 T.C. 609 (1977) (the Tax Court reversed its pro-taxpayer stance in Estate of George T. Klein, 61 T.C. 332 (1973), *rev'd,* 507 F.2d 617, 621 (7th Cir. 1974), *cert. denied,* 421 U.S. 991 (1975), and Vincent B. Rodgers, 51 T.C. 927 (1969), and held that pursuant to regulation § 1.1235-2(b), licensing agreements containing geographic limitations were not "sales and exchanges" of all substantial rights in a patent); David R. Blake, 67 T.C. 7, 13-16 (1976) (the Tax Court reversed its pro-taxpayer stance taken in Mros. v. Comm'r, 30 T.C.M. (CCH) 519 (1971), *rev'd,* 493 F.2d 813, 816 (9th Cir. 1974), and Fawick v. Comm'r, 52 T.C. 104 (1969), *rev'd,* 436 F.2d 655 (6th Cir. 1971) and held that based on regulation § 1.1235-2(b), licensing agreements containing field of use restrictions did not constitute "sales or exchanges" of all substantial rights in a patent); William W. Taylor, 29 T.C.M. (CCH) 1488, 1493-94 (1970) (transfer is not a sale where the rights to manufacture, use, and sell were not exclusive); PPG Indus., Inc., 55 T.C. 928, 1014 (1970) (transfers for a fixed term of years did not constitute the "sale or exchange" of all substantial rights in the technology).

v. Commissioner, a 1971 Sixth Circuit decision,[205] and *Mros. v. Commissioner*, a 1974 Ninth Circuit decision,[206] formulated a two-step test for section 1235 "transfers": What did the taxpayers actually give up, and what did the transferor retain?[207] In the recent decision, *Don Keuneman*,[208] the two-tier analysis of *Fawick* and *Mros*[209] was relied upon by the Tax Court in its denial of capital gains treatment to a licensing agreement containing a geographical limitation provision.[210]

The analogy by the Service from the traditional "sale or exchange" interpretation of the transfer language in section 1235 to the "transfer . . . in exchange" language of section 351(a), particularly with respect to transfers of secret information and know-how, has been almost complete. In Revenue Ruling 64-56, the Service ruled that a transfer will qualify under section 351 if the transferred rights extend to all of the territory of one or more countries and consist of all substantial rights therein, the transfer being clearly limited to such territory, notwithstanding the fact that rights are retained as to some other country's territory.[211]

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[205] 52 T.C. 104 (1969), *rev'd*, 436 F.2d 655 (6th Cir. 1971).

[206] 30 T.C.M. (CCH) 519 (1971), *rev'd*, 493 F.2d 813, 816 (9th Cir. 1974).

[207] *See Mros*, 493 F.2d at 816 (two-fold test—(1) what did the taxpayer actually give up, and (2) what did he retain after the transfer?); *Fawick*, 436 F.2d at 662 (two-pronged test—(1) what the holder has left after the transfer, and (2) what he relinquished to the transferee). Support for this two-pronged test in both cases was premised upon S. REP. No. 1622, 83d Cong., 2d Sess. 439-40, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4785, 5082-83. For a detailed discussion of *Mros, Fawick, Klein, Rodgers, Blake,* and Senate Report 1627, see Don Keuneman, 68 T.C. 609 (1977). *See also* Hagen, *Are Capital Gains Still Available Via Patent Fragmentation: A Current Analysis*, 43 J. TAX. 78, (1975); Rodgers, *Transfer of Patent Rights*, 61 A.B.A.J. 374 (1975).

[208] 68 T.C. 609 (1977).

[209] *See* note 204 *supra*.

[210] 68 T.C. at 612-19. The court noted that if a patent could be sliced into smaller segments, and the "all substantial rights" test satisfied merely by transferring all such rights with respect to the segment, capital gains treatment would be allowed despite the retention of valuable rights. *Id.* at 618. In contrast to *Keuneman*, in Vincent B. Rodgers, 51 T.C. 927, 930 (1969), the Tax Court limited the "substantial rights" test to merely the rights to "make, use, and sell" and rejected the Service's interpretation of section 1235 as found in Treas. Reg. § 1.1235-2(b).

[211] Rev. Rul. 56, 1964-1 C.B. 133, 135. *See also* notes 60-63, and 202 *supra*. *Compare Cohen*, *supra* note 20, at 40 (the Service's field of use restrictions are highly questionable in light of past judicial recognition of the validity of such provisions), *and* Note, *supra* note 22, at 54, (the Service's "sale or exchange" test is not supported by section 351 or the regulations), *with Duffy*, *supra* note 20, at 1290-92 (secret industrial know-how is capable of being sold for capital gains purposes to a purchaser who acquires the exclusive and perpetual right to use the know-how in a particular country and the right to prevent

Except for Revenue Ruling 64-56's response to a hypothetical problem, neither the courts nor the Service have had an opportunity to apply or interpret the ruling's restrictive field-of-use and geographic limitations to a licensing agreement of know-how in gross.[212]

The Service has also argued for the grafting of two other limitations upon section 351(a), namely, "exclusivity" and "in perpetuity."[213] Analogizing to its successes under section 1235, the Service in Revenue Ruling 64-56 emphasized that a transfer of exclusive rights is one element necessary to the finding that a transfer qualifies under section 351.[214] In the 1967 decision, *United States Mineral Products Co.*, the Service unsuccessfully raised the exclusivity issue with regard to the transfer of certain know-how[215] under the capital gains rules. Recognizing the inherent validity of the Service's argument as premised on the regulations under section 1235, the Tax Court examined the "licensing" agreement involved, and contrary to the Service's urging found

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the seller and others from disclosing or using the know-how in that country). The degree of resemblance between Rev. Rul. 64-56 and the Duffy formulation are uncanny.

[212] The closest a court has come to discussing geographic limitations in a know-how license may be found in United States Mineral Prods. Co., 52 T.C. 177 (1969) where the court explicitly held: "By granting to CAFCAN the exclusive right within the territorial limits of Canada to use and to grant to others the right to use the formulas and the design . . ." a "sale" occurred. *Id.* at 198-99. The primary authority cited by the Service to support its position in Rev. Rul. 64-56 was Lanova Corp., 17 T.C. 1178 (1952). Although recognizing that the transfer of the exclusive right to use an invention in the United States and other North and South American countries constituted a tax-free transfer under § 112(b)(5) (the predecessor of section 351; *see* note 25 and accompanying text *supra*), the court's primary focus was on a totally different issue, the basis for such assets. *Id.* at 1179. At no point in the opinion did the court ever discuss geographical limitations in licensing agreements. Totally contrary to the Service's position in 1964, there was every indication that geographical limitations and field-of-use restrictions were permissible. *See, e.g.*, R.N. Crank, 135 F. Supp. 242, 253 (W.D. Pa. 1955) (patent rights may be limited geographically or to a particular industry and still qualify as a sale). Language of similar breadth may be found in William S. Rouverol, 42 T.C. 186, 192-94 (1964).

[213] Treas. Reg. § 1.1235-2(b). *See* notes 201-203 and accompanying text *supra*. *See* Puschelberg v. United States, 330 F.2d 56, 60 (6th Cir. 1964) (exclusivity is a prerequisite to capital gains treatment in a patent transfer). *See also* Young v. Comm'r, 269 F.2d 89, 91-94 (2d Cir. 1959) (right to terminate at will is the retention of a substantial right); Rev. Rul. 156, 1969-1 C.B. 101 where the Service emphasized the importance of the exclusivity element in the transfer of a patent under section 351.

[214] *See* notes 201-203 and 213 and accompanying text *supra*.

[215] 52 T.C. at 191. The Service phrased its argument somewhat differently, urging that the exclusivity issue went to whether or not the formulas even constituted property under I.R.C. §§ 1221 or 1231.

that the transferor actually had granted an exclusive right to the transferee within the territorial limits of Canada to use, and to grant to others the right to use, the technical information in question.[216] In *Taylor-Winfield Corp.*, the Service again raised the argument that certain transfers of technology constituted no more than an exclusive grant of rights for a term of years followed by a nonexclusive grant of rights thereafter in perpetuity.[217] Not faring as well as the transferor in *United States Mineral Products Co.*, the taxpayer was unable to convince the Tax Court that *Mineral Products* was controlling.[218] Despite the presence of exclusivity language in the license, the Tax Court found that the retention of a sublicensing veto power by the transferor rendered the licensing agreement no more than a terminable license of unpatented technology and therefore was not a sale or exchange for capital gains purposes.[219]

The Service's final and most successful basis for attack upon transfers of know-how under section 1235 "sales or exchanges" has been the "in perpetuity" requirement. Attempting to clarify the meaning of this requirement, in the analogous context of a section 351 transfer as discussed in Revenue Ruling 64-56, the Service, in Revenue Ruling 71-564, held that a transfer of know-how under section 351(a) will constitute a qualified transfer if the rights are granted for a period lasting at least until the secret becomes public knowledge and is no longer protectible under the transferee country's laws.[220] The case law has unanimously sup-

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[216] *Id.* at 177-200. Reviewing the language of the CAFCAN agreement, *id.* at 188, the court concluded that an exclusive license had been granted with respect to the know-how. In contrast, the CAFCUS agreement although granting exclusive rights failed the "in perpetuity" test. *Id.* at 195. *See* notes 220-225 and accompanying text *infra*.

[217] 57 T.C. at 213.

[218] The court distinguished Mineral Prods. Co., 52 T.C. 177 (1969) on the grounds that the rights to sublicense was granted to the transferee in that case. Unlike *Mineral Prods. Co.*, in *Taylor-Winfield Corp.*, the transferee was precluded from sublicensing without the transferor's consent. In addition, the transferee was to hold the information in total confidentiality and secrecy. 57 T.C. at 219.

[219] Delving beneath the mere form of the agreement, namely an exclusive license in perpetuity, the court found the transaction to constitute no more than a terminable license of unpatented technology. *Id.* For similar treatment of the issue of exclusivity of the right to prevent unauthorized disclosures by the transferees, see Edward W. Reid, 50 T.C. 33 (1968); Commercial Solvents Corp., 42 T.C. 455, 469 (1964); E.I. DuPont de Nemours & Co. v. United States, 288 F.2d 904, 912 (Ct. Cl. 1961); Stalker Corp. v. United States, 209 F. Supp. 30 (E.D. Mich. 1962).

[220] Rev. Rul. 564, 1971-2 C.B. 179. More succinctly stated, the transfer must be for the life of the secret information.

ported this position with respect to the capital gains "sale or exchange" rules. In *Bell Intercontinental Corp. v. United States*, *PPG Industries, Inc.*,[222] and *Taylor-Winfield Corp.*,[223] grants for terms of years were denied capital asset status for failing the "in perpetuity" test.[224]

Amplifying its position in Revenue Ruling 64-56, the Service restated its position in another section 351 ruling:

> Secret information is sufficiently akin to patents to warrant the application, by analogy, of some of the principles of law relating to the *transfer* of patent rights. . . . The grant of patent rights . . . will constitute a transfer of property within . . . section 351 . . . only if the grant of these rights . . . would constitute a sale or exchange of property rather than a license for purposes of determining the character of gain or loss.
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> In order for a grant of patent rights to constitute a sale or exchange, the grant must consist of all substantial rights to a patent. . . . Likewise, in order for all substantial rights in a trade secret to be transferred, the transferor must transfer to the transferee the use of the trade secret for its full life . . . .[225]

Unfortunately the Service has totally ignored the policy and statutory construction grounds for distinguishing the meaning of the word "transfer" in section 1235 from its meaning in section 351, focusing instead upon the alleged sufficiency of kinship between secret information and patents. Revenue Ruling 71-564 is an excellent example of the confusion generated in this area by the Service's failure to distinguish the transfer issue from the property issue.

The major breakthrough for the taxpayer occurred in two decisions in 1973 and 1974. First, in the 1973 decision *E.I. DuPont de Nemours and Co. v. United States*, the Court of Claims was presented with the issue of whether a nonexclusive license of a patent constituted a qualifying "transfer" of property under sec-

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[221] 381 F.2d 1004, 1020-21, 1022-23 (Ct. Cl. 1967) (the right to terminate without notice, by either side, at the end of the first ten years of the agreement, constitutes the retention of a substantial right in the information under sections 1221 and 1222).

[222] 55 T.C. 928, 1013-15 (1970) (transfer for a term of years is not the sale of all substantial rights in the information under section 1221).

[223] 57 T.C. 205, 214-20 (1971) (the right to terminate at the end of ten years constitutes the retention of a substantial right in the information for purposes of section 1235).

[224] *See also* Pickren v. United States, 249 F. Supp. 560 (M.D. Fla. 1965), *aff'd*, 378 F.2d 595 (5th Cir. 1967) (twenty-five year transfer was not a transfer of all substantial rights in certain formulas).

[225] Rev. Rul. 564, 1971-2 C.B. 179, 180. *See also* note 202 *supra*.

tion 351.[226] Recognizing that the Service's position rested entirely upon the case law and regulations under section 1235,[227] and contrasting totally contradictory purposes expressed in the legislative history of the two statutory provisions,[228] the Court of Claims stated: "In other words, the capital gains concept of a 'sale and exchange' is simply irrelevant to section 351, which has a quite different purpose and an independent postulate."[229] The court, comparing the purposes of the two statutes, observed that the core of section 351 was continuity of interest and continuity of control, while to the contrary, section 1235 treatment was triggered only by the complete divestiture of any interest in the patent transferred.[230] Aptly, the court remarked: "It would be odd to hold that a transfer had to look most like a complete disposition in order to avoid being treated for tax purposes as a complete disposition."[231]

The total underpinnings of the Service's position having been eroded, the court found it only a small step to include a nonexclusive license of substantial value, commonly thought of in the commercial world as a positive business asset, within the definition of property for purposes of section 351.[232] In effect, therefore, the court focused primarily on the issue of whether a mutual exchange of valuable items had occurred.

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[226] 471 F.2d 1211, 1212-13 (Ct. Cl. 1973). For a detailed discussion of the court's "property" analysis see notes 34-38 and accompanying text *supra*.

[227] *Id.* at 1213. The Service relied heavily on the fact that original section 351 (§ 112(b)(5)) and the capital gains provisions both had their origins in closely related provisions of the Revenue Act of 1921. *Id.* at 1217. *Compare* ch. 136, § 202(c)(3), 42 Stat. 230 (1921) (current version at I.R.C. § 351) *with* ch. 136, § 206, 42 Stat. 232-33 (1921) (current version at I.R.C. §§ 1201-1254). The court quickly disposed of the Service's argument by noting that the great variance in purposes between section 351 and the capital gains provisions greatly outbalanced any elements of cognate origin or statutory juxtaposition. *Id.* at 1218.

[228] *Id.* at 1213-16. The court noted that the capital gains provisions use such language as "capital assets" and "sale/exchange", while section 351 is couched in terms of "property" and "transferred . . . in exchange." *Id.* at 1214. More importantly, the capitals gains provisions are concerned with total divestiture while the core of section 351 was "continuance-of-taxpayer-control." *Id.* at 1214-15. In effect section 351 was aimed at deferring tax until a true outside disposition was made. *Id.* at 1214. For a discussion of the legislative history behind section 351, see notes 25-31 and accompanying text *supra*. To ignore this distinction between section 351 and the capital gains provisions is to emasculate the 80% control requirement of section 351.

[229] *Id.* at 1217.

[230] *Id.* at 1214-18. *See also* note 225 *supra*.

[231] *Id.* at 1217.

[232] *Id.* at 1218. *See* notes 34-40 and accompanying text *supra*.

Barely a year later, in May of 1974, the Supreme Court sounded the death knell for the Service's section 1235-351 analogy. As discussed in part II of this article, the Supreme Court implicitly adopted the Restatement of Torts, section 757, definition of trade secret as a federal trade secret standard in *Kewanee Oil Co. v. Bicron Corp.*[233] In effect, the Restatement recognizes that any secret compilation of information may qualify as a protected interest as long as it gives the possessor of such information a competitive advantage over those who do not know it or use it.[234] Similar language had already been applied to the transfer of know-how in 1961, when foreshadowing *Kewanee,* the Court of Claims in *E.I. DuPont de Nemours & Co. v. United States* held: "In each case [transfers of patents and trade secrets] the transferee . . . gets more than mere information. Of greater importance, he obtains what he believes to be a competitive advantage, a means for commercial exploitation and reward."[235]

The importance of the *Kewanee* decision rests therefore in its implicit rejection of the two-step *Fawick-Mros*[236] test for determining what constitutes a transfer of "all substantial rights." As properly noted in *Kewanee,* the perspective from which a trade secret or know-how transfer must be viewed is from that of the transferee, not the transferor;[237] what the transferor has retained

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233 416 U.S. 470, 474 (1970). For a discussion of the specific impact of *Kewanee* in trade secret law, see notes 110-121 and accompanying text *supra.*

234 416 U.S. at 474. *See also* notes 110-193 and accompanying text *supra.*

235 288 F.2d 904, 911 (Ct. Cl. 1961).

236 *See notes* 207 and accompanying text *supra.*

237 The Restatement definition makes competitive advantage both an indicia of as well as an element of a trade secret. RESTATEMENT OF TORTS § 757 (1939), as cited in *Kewanee,* 416 U.S. at 474-75. In contrast, the value afforded the information received by the transferee is totally ignored under the *Mros-Fawick* two-step test. (493 F.2d at 816; 436 F.2d at 662). As noted in *DuPont,* 471 F.2d at 1215, running throughout all of the capital gains provisions is a requirement that the transferee fully and completely divest himself of any interest in the transferred asset. The Code determines that gain or loss is to be determined at the time of the transfer. Consequently, the only way to determine if a sale has occurred is to determine if the transferor has retained any interest that would indicate a transaction falling short of a sale. In contrast, the very purpose of section 351 is to avoid the complete divestiture of ownership of the information by the transferor. 471 F.2d at 1215. *See also* notes 26-28 and accompanying text *supra. See particularly,* S. REP. No. 265, 67th Cong. 1st Sess. 11 (1921), *reprinted in* 1939-1 C.B. (part 2) 188. As noted in the *DuPont* decision, to give meaning to the control element under section 351, yet insist upon a "sale or exchange" is to bring about "disparate results not rationally connected to the fundamental principle behind section 351." 471 F.2d at 1217. The nature of the *Kewanee* competitive-advantage test is perfectly suited for section 351. Once the

is irrelevant in a section 351 transfer, if the assets transferred to the transferee will result in a competitive advantage to him.

Once one shifts to a test of "commercial advantage" to the transferee, many of the Service's positions regarding qualifying "transfers" become less defensible. The transfer of a trade secret or know-how which confers a commercial advantage upon the transferee-possessor who operates in a particularly limited sphere of business is no less property or no less a qualified transfer simply because the transferee's business or market extends over a geographical area encompassing less than the geographic bounds of the transferee's country.[238] Similarly, commercial advantage transferred to a corporation in one particular field-of-use may be totally unaffected by the transferor's conveyance or retention of the right to convey identical rights to a different transferee in a totally distinct field-of-use.[239]

"perspective of the transferor" test is abandoned only one participant's vantage point remains, that of the transferee. This test was implicitly adopted in *DuPont*, 471 F.2d at 1219. The court noted that DuPont "handed over" something of value, received stock in exchange, there was no disposition to an outsider, and the transferee remained in control; in retrospect, the very form of transaction that section 351 was aimed at. *Id.* at 1219. Should the Service contend that such a broad approach would open the floodgates for tax evasion, I.R.C. §§ 482 and 367 remain as powerful protectors of the federal fisc. *Id.* at 1220.

[238] Clearly the Service, the courts, and the legal commentators have noted that section 1235 excludes licenses containing geographical limitations from the concept of sales of all substantial rights. *See, e.g.*, Don Kueneman, 68 T.C. 609 (1977); Estate of George T. Klein, 61 T.C. 332 (1973), *rev'd*, 507 F.2d 617, 621 (7th Cir. 1974), *cert. denied*, 421 U.S. 991 (1975); Treas. Reg. § 1.1235-2(b) (1965); Rev. Rul. 56, 1964-1 C.B. 133; Burke, *supra* note 20, at 755-57; Duffy, *supra* note 20, at 1290-92. However, once the analogy to section 1235 is removed, the prohibition on geographical limitations seems less supportable. The most that can be said about an agreement containing a geographical limitation is that it is not a sale. However, to qualify for section 351 treatment this is exactly what the transferor must argue. The very structure of the language of section 1235 recognizes that a license containing a geographical limitation is a transfer; the statute reads: "A transfer . . . of property consisting of all substantial rights . . . shall be considered the sale or exchange." The Service has never argued that such tainted licenses are not transfers, but merely they are not sales. See the Tax Court decisions in Estate of George T. Klein, 61 T.C. 332 (1973), *rev'd*, 507 F.2d 617, 621 (7th Cir. 1974), *cert. denied*, 421 U.S. 991 (1975); Vincent B. Rodgers, 51 T.C. 927 (1969). There is no reason to read into the word "transfer" a requirement that the transfer be inclusive within the entire geographic bounds of a country.

[239] Recently, field-of-use limitations have also run into stiff opposition. *See* Blake v. Comm'r, 67 T.C. 7 (1976); Mros v. Comm'r, 30 T.C.M. (CCH) 519 (1971), *rev'd*, 493 F.2d 813 (9th Cir. 1974); Fawick v. Comm'r, 52 T.C. 104 (1969), *rev'd*, 436 F.2d 655 (6th Cir. 1971). *See also* the Revenue Ruling and articles discussed in note 200-01 *supra*. The same analysis used in note 238 *supra* is equally applicable, if not more so, to field-of-use restrictions. If a sale is the last form of transaction and the transferor means to effect under

As for the "exclusivity" and "in perpetuity" requirements espoused by the Service in the recent revenue rulings,[240] an analogy to field-of-use and geographic limitations analysis, as discussed above, may open to the taxpayer new avenues of attack upon the Service's position. By focusing on the broad meaning of the word "transfer" and by emphasizing the "competitive advantage" test of the Restatement and *Kewanee*,[241] the taxpayer may successfully argue that grants for less than the life of the trade secret or know-how, or retention by the transferor of the right to license others besides the transferee, may not appreciably lessen the advantage gained by the transferee. As discussed earlier, if the two-tier "what-has-been-retained" test of *Mros* and *Fawick*[242] is not applicable to a section 351 transfer, the transferor's retention of certain substantial rights should only preclude section 351 treatment if the transferee's right (competitive advantage) is materially impaired or diminished. Specific factual settings therefore must be examined to determine what effect such limitations may have upon the transferee. In addition, the Service always has sections 482 and 367 to fall back on in the event of a taxpayer's attempt to evade taxes through a section 351 transaction.[243]

In conclusion, the qualified "transfer" requirement of section 351 has often been confused with, or lost in, the maze of cases concerning the definition of the word "property" for purposes of section 351. The Service's guidelines for what constitutes a bona fide section 351 transfer have been even more befuddled as a result of its misplaced reliance upon an unfounded and insupportable section 1235-351 analogy. In light of the *DuPont* rejection of the analogy between sections 1235 and 351,[244] the taxpayer has been granted a second opportunity to fashion transfer guidelines more consistent with the purpose and rational underlying section 351.

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section 351, inclusion of a field-of-use restriction is one means recognized by the Service to avoid such a result. *See* Treas. Reg. § 1.1235-2(b) (1965).

[240] *See* the discussion of Rev. Rul. 64-56 and Rev. Rul. 71-564 at notes 202 and accompanying text *supra*.

[241] *See* the discussion of the Restatement definition of trade secret, as discussed in *Kewanee* at notes 110-193 and accompanying text *supra*.

[242] *See* notes 207-09 and accompanying text *supra*.

[243] I.R.C. §§ 367, 482. *See* the discussion in note 237 and accompanying text *supra*.

[244] *See* notes 226-32 and 237 and accompanying text *supra*.

In conclusion, the primary goal of this section has been to make the reader aware of the numerous weaknesses in the Service's already attenuated line of analyses regarding the word "transfer." Until the courts are presented with specific factual settings, it is difficult to speculate as to the potential erosion of the Service's position in the future.

CONCLUSION

The foregoing analysis has attempted to demonstrate that the standards adopted by the Service with respect to transfers of know-how under section 351 are substantially without legal foundation. The taxpayer seeking tax-free exchange treatment would be well-advised to structure his agreement so that information transferred is treated by the contracting parties as property. Common sense also demands that the taxpayer label his information in a manner consistent with the demanding property rules under Revenue Procedure 69-19, and the equally onerous "transfer" rules of Revenue Rulings 64-56 and 71-564. However, the taxpayer must also recognize that the Service's rules are distortions of the law. If the taxpayer is willing to litigate with the Service, he should attempt to stretch the concepts of property and transfer to their limits. Once in court, the taxpayer's chances of success should be far greater than those of the Service.

DAMAGES IN SECTION 1983 ACTION CONTROLLED BY STATE LAW: *Jones v. Hildebrandt*, 550 P.2d 339 (Colo. 1976), *cert. dismissed*, 97 S. Ct. 2283 (1977).

INTRODUCTION

On June 16, 1977, the United States Supreme Court in a per curiam opinion dismissed a petition for certiorari in the case of *Jones v. Hildebrant.*[1] This opinion cast serious doubts upon the continuing validity of the Colorado Supreme Court's interpretation of the interplay between actions brought pursuant to 42 U.S.C. section 1983[2] and the state's wrongful death statute.[3]

This comment will first examine the Colorado court's rationale in dismissing plaintiff's section 1983 action. Then the questions raised—and as yet left unanswered by the United States Supreme Court's dismissal—will be discussed with an eye toward the potential for a separate section 1983 recovery in Colorado today.

I. THE WRONG

On the evening of February 5, 1972, Denver police officers Hildebrant and Moran, responding to a silent alarm, came upon plaintiff's son, Larry Jones, in an alley next to an abandoned building. Believing Larry to be a possible burglary suspect, Hildebrant gave chase, and when the suspect would not stop, Officer Hildebrant drew his weapon, shot, and killed Larry Jones.[4]

Mrs. Ruby Jones, mother of the deceased, brought an action on her own behalf against Officer Hildebrant and the City and County of Denver in the state District Court for the City and County of Denver. She sought compensatory and punitive damages for the allegedly unlawful killing of her son. As amended, her complaint stated three claims for relief: (1) for battery under

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[1] 550 P.2d 339 (Colo. 1976), *cert. dismissed,* 97 S. Ct. 2283 (1977).

[2] Civil Rights Act of 1871, ch. 22, § I, 17 Stat. 13 (codified at 42 U.S.C. § 1983 (1970)).

[3] COLO. REV. STAT. § 13-21-202 (1973). *Action notwithstanding death.*

> When the death of a person is caused by wrongful act, neglect, or default of another, and the act, neglect, or default is such as would, if death had not ensued, have entitled the party injured to maintain an action and recover damages in respect thereof, then, and in every such case, the person who or the corporation which would have been liable, if death had not ensued, shall be liable in an action for damages notwithstanding the death of the party injured.

[4] Petitioner's Brief for Certiorari at 3, Jones v. Hildebrant, 97 S. Ct. 2283 (1977).

state law; (2) for negligence under state law; (3) for violation of federal constitutional rights.[5] The state court treated the first two claims for relief as being authorized by the state wrongful death statute, and the third was treated as authorized by section 1983.[6]

The defendants admitted the shooting but asserted that Officer Hildebrant was acting within the scope of his authority as a Denver law enforcement officer.

The case proceeded to trial on all of plaintiff's claims. At the close of proof, defendants moved to dismiss plaintiff's federal claim. The trial judge granted the motion on the ground that the section 1983 claim was "merged" with the state law claims, and that no relief different from that recoverable under the state-law claims was available under section 1983. The case thus went to the jury on plaintiff's state-law claims only. On the issue of damages, the jury was instructed that the plaintiff was limited to recovering the net pecuniary loss she sustained as a result of her son's death, with a maximum allowable recovery of $45,000;[7] future earnings, loss of society, and exemplary damages were held to be unrecoverable under the state wrongful death statute.[8] The jury resolved the issues of liability under state law in favor of the plaintiff and returned a verdict of $1,500. The trial judge denied a motion for a new trial.[9]

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[5] 550 P.2d at 341.

[6] The complaint as filed was drawn in common law pleading style and made no specific reference to either the state wrongful death provision or section 1983. However, all courts in the case have construed claims one and two as being under the wrongful death statute and claim number three as being authorized by section 1983.

[7] COLO. REV. STAT. § 13-21-203 (1973). *Limitation on damages.*

> (1) All damages accruing under section 13-21-201 shall be sued for and recovered by the same parties and in the same manner as provided in section 13-21-201, and in every such action the jury may give such damages as they may deem fair and just, with reference to the necessary injury resulting from such death, to the surviving parties who may be entitled to sue; and also having regard to the mitigating or aggravating circumstances attending any such wrongful act, neglect, or default; except that if the decedent left neither a widow, widower, nor minor children, nor a dependent father or mother, the damages recoverable in such action shall not exceed forty-five thousand dollars. No action shall be brought and no recovery shall be had under both section 13-21-201 and section 13-21-202 and in all cases the plaintiff is required to elect under which he will proceed.

[8] For a critical discussion of the Colorado pecuniary loss limitation, see, Note, *Blind Imitation of the Past: An Analysis of Pecuniary Damages in Wrongful Death Actions*, 49 DEN. L.J. 99 (1972) (authored by David K. Rees, counsel for plaintiff in *Jones*).

[9] Petitioner's Brief for Certiorari at 2, Jones v. Hildebrant, 97 S. Ct. 2283 (1977).

A. *Appeal*

Mrs. Jones then appealed the lower court's verdict on the issue of damages. Of the three allegations made on appeal, only one, petitioner's claim that the federal section 1983 cause of action should not have been "merged" with the state wrongful death action, will be discussed in this comment.[10]

In support of the uniqueness of her federal claim, petitioner advanced four distinct theories which were recognized and discussed by the Colorado court.[11] The first theory, which was described by Justice Hodges in his majority opinion as being "confusingly stated," was that petitioner's "civil right to her son's life," as recognized by the state wrongful death statute, "was denied her without due process of law through his wrongful killing."[12] The court interpreted this claim as being solely an attempt to exercise a right to sue for damages. The court then turned to a discussion of what constitutes a right to "property" or "liberty" as set forth in the recent United States Supreme Court case, *Paul v. Davis.*[13]

In *Davis,* a section 1983 action for injuries allegedly inflicted upon plaintiff's reputation, the Court ruled that the right to sue for defamation was not a "liberty" or "property" right protected by the fourteenth amendment.[14]

On the basis of this decision, the Colorado court reached the conclusion that

> [t]he right to sue becomes a right protected by the Fourteenth Amendment only when the statutorily guaranteed access to the courts is denied. Therefore, where, as here, the state allows a plaintiff to bring her suit, she is not deprived of any of her civil rights without due process of law.[15]

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[10] Mrs. Jones asserted three issues on her appeal to the Colorado Supreme Court: (1) Her damages under the wrongful death statute were unconstitutionally restricted by the net pecuniary loss rule; (2) her recovery was inadequate, as a matter of law; and (3) additional damages should have been permitted under her section 1983 claim because that cause of action was not limited by the pecuniary loss rule. 550 P.2d at 341.

[11] *Id.* at 341-45.

[12] Justice Hodges wrote the opinion for the majority. Justice Kelly did not participate. Chief Justice Pringle, joined by Justice Groves, dissented, saying, "I respectfully dissent. I do not believe that Colorado's judicial limitation of net pecuniary loss as a measure of damages for wrongful death applies to actions founded upon 42 U.S.C. § 1983 (1970)." *Id.* at 346.

[13] 424 U.S. 693 (1976).

[14] *Id.* at 712.

[15] 550 P.2d at 343.

The second of plaintiff's arguments was that although section 1983 does not expressly create a wrongful death action for a violation of civil rights, a different section of the same act, section 1988,[16] "authorizes the incorporation into federal law of state wrongful death remedies to vindicates of civil rights that result in death."[17] The court agreed with petitioner's claim on this point and also agreed that the purpose of the incorporation was to "effectually implement the policies of the legislation."[18] However, the court would not accept the second part of plaintiff's argument that although section 1988 required incorporation of state law in certain circumstances it did not require the acceptance of the state limitations regarding damages. The Colorado Supreme Court concluded

> that Colorado's wrongful death remedy would be engrafted into a §1983 action if brought in a federal court. However, because the instant suit was brought in State court and joined with a suit under the state wrongful death statute, the trial court properly ruled that the two actions were merged so that the §1983 claim should be dismissed.
>
> Furthermore, because the allowable damages are such an integral part of the right to bring a wrongful death remedy, we believe the state's law on damages should also apply.[19]

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[16] 42 U.S.C. § 1988 (1970): *Proceedings in vindication of civil rights.*

> The jurisdiction in civil and criminal matters conferred on the district courts by the provisions of this chapter and Title 18, for the protection of all persons in the United States in their civil rights, and for their vindication, shall be exercised and enforced in conformity with the laws of the United States, so far as such laws are suitable to carry the same into effect; but in all cases where they are not adapted to the object, or are deficient in the provisions necessary to furnish suitable remedies and punish offenses against the law, the common law, as modified and changed by the constitution and statutes of the State wherein the court having jurisdiction of such civil or criminal cause is held, so far as the same is not inconsistent with the Constitution and laws of the United States, shall be extended to and govern the said courts in the trial and disposition of the cause, and, if it is of a criminal nature, in the infliction of punishment on the party found guilty.

[17] *Id.*

[18] The Colorado court as 550 P.2d 339, 343, n.4, set forth the proposition that federal courts have ruled that section 1988 permits the incorporation of the state's nonabatement statutes and wrongful death statutes into section 1983 actions in order to effectively implement the policies of that legislation. In support of this proposition the court referenced the following cases: Spence v. Staras, 507 F.2d 554 (7th Cir. 1974); Hall v. Wooten, 506 F.2d 564 (6th Cir. 1974); Brazier v. Cherry, 293 F.2d 401 (5th Cir. 1961); Javits v. Stevens, 382 F. Supp. 131 (S.D.N.Y. 1974); Troutman v. Johnson City, 392 F. Supp. 556 (E.D. Tenn. 1973).

[19] 550 P.2d at 344.

The court also rejected petitioner's third theory of recovery, "that a federal wrongful death remedy impliedly exists in section 1983, independent of the state wrongful death remedies."[20] While acknowledging that the United States Supreme Court had ruled that federal wrongful death remedies impliedly exist in some areas of the law,[22] the court decided to base its decision on three other factors: (1) The court's perception of Congressional intent not to preempt state remedies in the area of wrongful death, (2) the adequacy of the state remedy in death cases to vindicate civil rights violations, and (3) the "overwhelming acceptance of state remedies in the federal courts."[23]

Petitioner's final theory for obtaining a separate recovery under her section 1983 claim was that she was deprived of her own constitutional rights. In the words of Justice Hodges, "[S]he alleges in her complaint that *her* rights were violated because her child's right to life, his freedom from physical abuse and intimidation, and his right to equal protection of the laws were violated."[24] The court concluded, however, that these deprivations were really those of the son and that

> one may not sue for deprivation of another's rights under §1983, and that a cause of action can be maintained only by the "person injured." She therefore cannot sue in her own right for the deprivation of her son's rights apart from her remedy under the wrongful death cause of action.[25]

Furthermore, the court concluded that the state, by wrongfully killing Mrs. Jones' son, did not directly attempt to restrict her own personal decisions relating to procreation, contraception, and child rearing which were involved in cases such as *Griswold v. Connecticut*[26] and *Meyer v. Nebraska.*[27] The court concluded:

> Although the death of a family member represents a loss to her, we nonetheless, are of the opinion that § 1983 was not designed to

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[20] *Id.* at 344.

The case acknowledged by the court was Morange v. States Marine Lines, 398 U.S. 375 (1970), where the United States Supreme Court held that an implied action for wrongful death based upon the seaworthiness of a vessel was maintainable under federal maritime law. *Id.* at 345, n.10.

[22] 55 P.2d 339.

[23] *Id.* at 345.

[24] *Id.* at 345 (emphasis added).

[25] *Id.* at 345 (footnotes omitted).

[26] 381 U.S. 479 (1965).

[27] 262 U.S. 390 (1923).

> compensate for those collateral losses resulting from injuries to others. Otherwise damages would infinitely extend not only to parents and children, but to siblings and perhaps even to a "family" of close friends. *The interests protected by §1983 are adequately vindicated when actions are brought by injured parties themselves, or at their death, by those designated in our wrongful death statute.*[28]

II. THE RIGHT

As is so often the case in legislation born out of compromise, section 1983 is general in its language and utilizes terms not carefully defined. Courts which have sought guidance within the provisions of the statute itself have been frustrated by its lack of specificity. Others, which have turned to the legislative history of the act, have found strong advocacy in favor of a multitude of positions. Thus, lawmakers have found in section 1983 a flexible legal tool. Passed in the post-Civil War reconstruction period to provide a remedy for plaintiffs who were not receiving adequate protection from state laws, it lay dormant for almost half a century.[29]

The case in which the statutory skeleton of section 1983 was first firmly fleshed out by the Court was *Monroe v. Pape.*[30] *Monroe* involved an illegal search and seizure of a black couple's home by thirteen Chicago policemen.[31] In his opinion, Justice Douglas examined the legislative history of the section and formalized "three main aims" of the act: (1) To "override certain kinds of state laws"; (2) to "provide a remedy where state law was inadequate"; and (3) to provide "a federal remedy where the state remedy, though adequate in theory, was not available in practice."[32] These three goals of section 1983 as formulated by Justice Douglas are significant in that they have provided the authority by which subsequent courts have been able to expand the scope of the section 1983 cause of action.

After *Monroe,* there was a rapid increase in cases filed under section 1983.[33] Many offenses which had previously been actiona-

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28 550 P.2d at 345 (emphasis added).

29 Comment, *The Civil Rights Act: Emergence of an Adequate Federal Civil Remedy,* 26 IND. L.J. 361, 362 (1951).

30 365 U.S. 167 (1961).

31 *Id.* at 174.

32 *Id.* at 183.

33 According to one source:

> Between the enactment of the statute [§ 1983] in 1871 and 1939, only 19 §

ble only in state courts under state tort theories became section 1983 violations.

More recently, the Court, in an attempt to stem the "rush to the federal" courthouse,[34] has begun to give a more restrictive interpretation to the prerequisites of a section 1983 cause of action.[35]

In *Paul v. Davis*[36] the Court made a direct attack upon the substantive rights protected under the fourteenth amendment and thus actionable under section 1983.

In *Davis,* an individual attempted to secure damages under section 1983 against police officers for alleged damage to reputation. The plaintiff's picture had been circulated on a flyer identifying "active shoplifters" despite the fact that charges against the plaintiff for shoplifting had been dropped.

The Court recognized that the police activity would have been actionable under the law of defamation in the state court, but ruled that this alone was insufficient to support a section 1983 action even though state officials happened to be the defendants. This decision relied on the fact that in addition to the "under color of state law" requirement, section 1983, unlike state tort actions, required the deprivation of a constitutionally protected right. Unlike the clearly unconstitutional search and seizure present in *Monroe,* the plaintiff in *Paul v. Davis* was unable to point to any specific constitutional guarantee safeguarding one's reputation from state intervention. Thus he could show no cognizable liberty deprivation. The Court observed that the due process clause alone was not in itself a source of protected liberty interests so as to become an embodiment of general tort law.

> 1983 cases were reported. In fiscal 1960, the year prior to *Monroe,* only 280 cases were filed. By 1970, the number had mushroomed to 3,586, and the upward trend continued in 1971 with a 30 percent increase to 4,609. One estimate placed the number of actions filed in 1973 at approximately 8,000.

Note, *Section 1983 and Federalism: The Burger Court's New Direction,* 28 FLA. L. REV. 904, 915 (1976).

[34] Aldisert, *Judicial Expansion of Federal Jurisdiction: A Federal Judge's Thoughts on Section 1983, Comity and the Federal Caseload,* 1973 LAW & SOCIAL ORDER 557, 559.

[35] For a discussion of the post-*Monroe* restrictions on the Civil Rights Act, See, Note, *Section 1983 and Federalism: The Burger Court's New Direction,* 28 FLA. L. REV. 904 (1976); Note, *Limiting the Section 1983 Action in the Wake of Monroe v. Pape,* 82 HARV. L. REV. 1486 (1969); Comment, *Section 1983 and the New Supreme Court: Cutting the Civil Rights Act Down to Size,* 15 DUQ. L. REV. 49 (1976).

[36] 424 U.S. 693 (1976).

Davis was a verbalization of the Court's growing disenchantment with section 1983 as a cure-all statutory remedy. It was also the case cited by the Colorado court in its rejection of Mrs. Jones' section 1983 claim. At the time *Jones* came to trial in Colorado, it was clear, under *Monroe,* that civil rights suits could be brought against state officials alleging specific constitutional deprivations such as illegal search and seizure. This protection was specifically provided for by the fourteenth and fifteenth amendments. However under *Davis,* other interests such as reputation were not actionable under section 1983 due to the Court's failure to recognize them as being fundamental rights. Other than these specific cases, lower courts had little upon which to base decisions in the area.[37] Yet it was clear that fears of a federalization of the state tort system had prompted a new wave of court-imposed limitations on section 1983 actions.

Some issues, such as what rights were protected under section 1983, had been established as clearly federal concerns. For other issues, such as which statute of limitation to apply, the use of state law was well settled.[38] Other issues, however, such as the survivability of actions, defenses available, and measure of damages, were not so easily categorized. For assistance, the courts looked to a second provision of the Civil Rights Act.

Section 1988 addressed the question of what law should apply in proceedings taken in vindication of civil rights. The section provides that federal law shall control where "suitable" and that state law shall be used to achieve the purposes of the act or to provide suitable remedies where federal law is deficient.[39]

This concept, however, is more simply stated than applied as is shown in the almost ten years of litigation surrounding the infamous section 1983 case, *Shaw v. Garrison.*[40]

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[37] One test proposed by commentators is Judge Friendly's opinion in Johnson v. Glick, 481 F.2d 1028 (2d Cir. 1973), where it was suggested that conduct which "shocked the conscience," as defined in cases such as Rochin v. California, 342 U.S. 165 (1952), would allow an action to be brought under section 1983. Comment, *Section 1983 and the New Supreme Court: Cutting the Civil Rights Act Down to Size,* 15 DUQ. L. REV. 49 (1976).

[38] In O'Sullivan v. Felix, 233 U.S. 318 (1914), an action arising out of the predecessors of 42 U.S.C. § 1983, it was held that there was no federal limitations statute applicable to a civil damage action under the federal civil rights statutes and that the limitation statutes of the state in which the cause of action arose controlling.

[39] 42 U.S.C. § 1988 (1970).

[40] 391 F. Supp. 1353 (E.D. La. 1976), *rev'd sub nom.* Robertson v. Wegmann, ___ U.S. ___ (1978). *See* note 44, *infra.*

In *Shaw*, a civil action was brought by plaintiff against Garrison and others with whom he allegedly conspired to deprive Shaw of his civil rights by prosecuting him in bad faith for conspiracy to assassinate President Kennedy.[41]

After the commencement of the action, but prior to trial, the plaintiff died. He was not survived by any of the classes of individuals upon whom an action, other than one for damage for property, inured under Louisiana law.

It was clear that state law could be properly incorporated into section 1983 when it furthered the court-interpreted purposes of the Civil Rights Act.[42] In *Shaw*, however, the more difficult situation was presented. The district court was forced to decide whether to incorporate a state survival provision it felt was contrary to the purpose of section 1983 and allow the action to abate or to turn to federal law. The court refused to apply state law, finding it inconsistent with federal law, and in its place created a "federal common law of survival in civil rights actions in favor of the personal representative of the deceased."[43] Thus, at the time *Jones* came to trial in Colorado, *Shaw* clearly stood for the proposition that state law need not be incorporated via section 1988 when it stood in opposition to the purposes of section 1983.[44]

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[41] The complaint alleged causes of action under 42 U.S.C. §§ 1983, 1985, and 1986.

[42] 42 U.S.C. § 1988 (1970). The Supreme Court said of section 1988 in Sullivan v. Little Hunting Park, Inc., 396 U.S. 229 (1969):

> This means, as we read § 1988, that both federal and state rules on damages may be utilized, whichever better serves the policies expressed in the federal statute. The rule of damages, whether drawn from federal or state sources, is a federal rule responsive to the need wherever a federal right is impaired.

Id. at 240 (citations omitted).

[43] 391 F. Supp. at 1368. A similar result was obtained in the following cases: Spence v. Stares, 507 F.2d 554 (7th Cir. 1974); Basista v. Weir, 340 F.2d 74 (3d Cir. 1965); Rhoads v. Horvat, 270 F. Supp. 307 (D. Colo. 1967); Washington v. Official Court Stenographer, 251 F. Supp. 945 (E.D. Pa. 1966); Tracy v. Robbins, 40 F.R.D. 108 (C.D.S.C. 1966); Antelope v. George, 211 F. Supp. 657 (N.D. Idaho 1962).

[44] Subsequent to the dismissal of certiorari in *Jones*, Shaw v. Garrison, 391 F. Supp. 1353 (E.D. La. 1976), was first affirmed by the United States Court of Appeals for the Fifth Circuit, 545 F.2d 980 (1977), and then reversed by the Supreme Court, *sub nom.* Robertson v. Wegmann, ___ U.S. ___ (1978). Three justices, including two of the dissentors in *Jones* (White and Brennan), joined in a strongly worded dissent.

The majority opinion accepted the basic thrust of the plaintiff's argument that state law need not be incorporated into section 1983 actions when inconsistent with the purposes of the act, yet ruled that in the situation presented, Louisiana law was not so at odds with the purposes of section 1983 as to be stricken in favor of federal common law. Robertson v. Wegmann, ___ U.S. ___ (1978).

This was the precedent which Mrs. Jones presented to the Colorado Supreme Court upon appeal. She argued that the restrictive Colorado provisions regarding damages were too inconsistent with the purposes of section 1983 to be incorporated into the federal statute. It was argued that the Colorado Supreme Court should reject the state's damage limitations just as the federal district court had rejected Louisiana's limitation on survivability.[44]

III. THE REMEDY

If a plaintiff's interests are to be protected by a state statute to such an extent that the federal action may be dismissed, one would think that the remedy available in the state courts would be completely coextensive with that available in the federal courts. However, an examination of the provisions of the Colorado wrongful death statute quickly points out severe limitations present at the state level which are not present in the federal action.

The Colorado wrongful death statute, as interpreted by the Colorado Supreme Court, is limited only to the recovery of compensatory damages for the loss of decedent's services and support and does not permit the recovery of damages for the survivor's grief, sorrow, and emotional distress.[45] In addition, the trial court in *Jones* ruled that the wrongful death statute did not permit the recovery of punitive damages, nor a recovery in excess of $45,000 because the plaintiff was not dependent upon the deceased.[46] Also, Colorado has expressly described the wrongful death action as being only a "property tort action" and not as a tort action "for injuries done to the person."[47] Finally, the Colorado statute says nothing about compensation for the loss of a civil right.

The Court admittedly limited the decision:

> Our holding today is a narrow one, limited to situations in which no claim is made that state law generally is inhospitable to survival of § 1983 actions and in which the particular application of state survivorship law, while it may cause abatement of the action, has no independent adverse effect on the policies underlying § 1983. A different situation might well be presented . . . if state law "did not provide for survival of any tort actions," or if it significantly restricted the types of actions that survive. We intimate no view moreover, about whether abatement based on state law could be allowed in a situation in which deprivation of federal rights caused death.

Id. at ___ (citations omitted).

[45] 550 P.2d at 342.

[46] *Id.* at 341.

[47] Fish v. Liley, 120 Colo. 156, 208 P.2d 930 (1949).

Clearly these limitations do not apply to an action brought pursuant to section 1983. The Colorado court realized that it was under a duty, when evaluating the section 1983 claim, to interpret and apply federal law. The court agreed with the plaintiff that section 1983 did not expressly create a survival action, and that section 1988 required the incorporation of state law. However, it was at this point that the Colorado court decided that section 1988 mandated the conclusion that the Colorado remedy constituted the exclusive determinate of damages and remedies available under a section 1983 action.[48] The court acknowledged that it was applying federal law via section 1988, yet failed to look beyond the familiar state law to a body of well established federal common law in fashioning a remedy.[49]

The Colorado court based its dismissal of plaintiff's section 1983 action upon the grounds that it was "merged" with the state statutory remedy. The court did not further define this term nor did it cite authority for the proposition. The commonly accepted definition of the term "merger" as applied to causes of actions refers to the situation where one person takes or acquires "a remedy in legal estimation higher than that he already possesses for the same right."[50] It is then said that by exercising your right to the greater remedy you allow the lesser right to merge into the cause of action pursued.[51]

It is hard to see how this definition applies to a section 1983 cause of action brought in a state court. Section 1983 actions by definition must involve constitutional violations which would

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[48] The Colorado court in *Jones* stated that the state's wrongful death limitations would be "engrafted" into a section 1983 action even if brought in a federal court. 550 P.2d at 344. However, section 1983 does not mandate this result. As discussed above section 1988 operates only when federal common law is found deficient, and then incorporates state law only to the extent that it is inconsistent with the purposes of the Act. 42 U.S.C. § 1988 (1970).

[49] It has been held that where federally protected rights have been invaded, the courts will adjust their remedies so as to grant the necessary relief. This is true even though the federal statute provides for only a general right to sue for such invasion and does not address an available remedy to make good the wrong done. Bell v. Hood, 327 U.S. 678 (1946).

[50] BLACK'S LAW DICTIONARY 1140 (4th ed. rev. 1968).

> The term merger has also been used in criminal law where the identical criminal act constitutes two or more offenses such as where the same act is both a felony and a misdemeanor. The rule is the lower grade merges with the higher. State v. Smith, 190 Mo. 706, 90 S.W. 440 (1905).

[51] BLACK'S LAW DICTIONARY 1140 (4th ed. rev. 1968).

presumptively be placed on a legal tier higher than that of state common law or statutory causes of action.

Section 1983 is a vehicle for the vindication of individual constitutional rights. Justice Harlan's concurring opinion in *Monroe* stressed that the "deprivation of a constitutional right is significantly different from and more serious than a violation of a state right and therefore deserves a different remedy even though the same act may constitute both a state tort and the deprivation of a constitutional right."[52] This description of section 1983 hardly seems to place it in the mergable category.

Possibly, the Colorado court meant by the term "merger" that two actions were identical from the standpoint of remedies available; however, since section 1983 provides a more extensive remedy than the Colorado wrongful death act, with its $45,000 maximum recovery, this does not seem to be the case. In comparison to the plaintiff's wrongful death actions, section 1983 is clearly a separate legal remedy. The section was enacted for a specific purpose, at a different time, granting jurisdiction for different offenses, to remedy different ills, in a different way than does the Colorado wrongful death statute.[53] Section 1983 has no net pecuniary loss limitation imposed. Section 1983 has no statutory limitation for individuals without dependents. Additionally, the section has been interpreted to allow punitive damages.[54] The two actions are clearly not identical, nor do they provide equal remedies.

The identity of remedies was crucial to the Colorado Supreme Court's ruling, but, as seen above, the remedies simply are not identical. Under federal law the loss of a civil right alone is compensable, even though it is not accompanied by a pecuniary loss.[55] The measure of compensation in section 1983 actions, though at times difficult to assess, has been considered great.[56]

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[52] 365 U.S. at 196.

[53] It has been generally held that where two causes of action are granted by statute without the second enactment expressly or impliedly supplanting or abrogating the first, the newer remedy is not to be considered exclusive but rather cumulative. This is true even where the separate remedies are given under state and federal statutes. Jenkins v. S. Ry. Carolina Div., 152 S.C. 386, 150 S.E. 128 (1929) (allowing joinder of a cause of action brought under Federal Employers Liability Act and a state wrongful death statute).

[54] Basista v. Weir, 340 F.2d 74 (3d Cir. 1965).

[55] Rhoads v. Horvat, 270 F. Supp. 307 (D. Colo. 1967).

[56] Faber v. Rizzo, 363 F. Supp. (E.D. Pa. 1973).

The Colorado decision limiting plaintiffs solely to the wrongful death provisions has prevented every consideration of whether or not such plaintiffs should be compensated for a constitutional deprivation.

IV. THE RATIONALE

The Colorado court dismissed plaintiff's section 1983 claim, saying that her rights were adequately protected by the state cause of action and the state remedy. This conclusion was reached by an analysis which emphasized that if a federal cause of action existed—whether brought in a federal or state court—it would be controlled completely by the state damage limitations. This basic assumption lies at the heart of the Colorado court's rejection on all four of plaintiff's arguments for the establishment of a section 1983 claim.

Apparently, what the Colorado court did was to look at the interest sought to be protected and decide that it either was not protectable under the rationale of *Davis* or was adequately protected by the bringing of a wrongful death action in state court. Thus, the section 1983 action was dismissed.

The same rationale was used in rejecting plaintiff's second argument for her section 1983 claim. The court agreed with plaintiff that the statute itself was silent on survival and that section 1988 required resort to state law to the extent that such state law was compatible with federal law. However, the majority of the court would not accept petitioner's contention that the Colorado statutory limitations, such as the net pecuniary loss provision, were totally incompatible with the interests protected under section 1983. By accepting state law as being completely compatible with the purposes of section 1983, the court was not forced to apply the next echelon of authority—federal common law.[57]

Petitioner's third argument began where her second left off. The claim stressed that, even in the absence of section 1988 (directing courts to state law where compatible), section 1983 itself created a *constitutional* cause of actions independent of state law limitations. The Colorado court recognized that such a right to federal wrongful death remedies impliedly did exist in some limited areas; however, they refused to accept these cases as being

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[57] Adickes v. S.H. Kress & Co., 398 U.S. 144 (1970).

controlling in *Jones*. Instead, the court relied upon a perceived Congressional intention not to preempt the state's "carefully wrought wrongful death remedies."[58]

While this argument has some validity it is by no means conclusive. Federal courts do develop rules of law and decisions in selected areas of particular federal concern.[59] It would appear that the protection of civil rights as defined in the Constitution would be such an area of federal concern even in the absence of the provisions of section 1988.

In *Morange v. States Marine Lines Inc.*,[60] the case acknowledged by the Colorado court, a plaintiff sought to bring a wrongful death action against the owner of a vessel upon which her husband had been killed. At the time of the husband's death the vessel was within the navigable waters of the state of Florida. Neither federal statute nor Florida law provided for a wrongful death action based upon the seaworthiness of a vessel. Yet, in *Morange* the Court held that an action does lie under general maritime law for death caused by violation of general maritime duties. Thus, the creation of remedies for wrongful death is not limited merely to statutory law, and there exists authority for the creation of wrongful death actions within federal common law also. This position, however, was rejected by the Colorado court in favor of a perceived Congressional intent not to preempt state wrongful death remedies. Yet, federal preemption has been exercised in at least two areas involving wrongful death actions. A federal policy in favor of the survivability of wrongful death actions and the awarding of punitive damages has been applied as a matter of federal common law in clear opposition to state policies. Such preemption has been exercised *whenever* state law has been found to be in opposition to the purpose of section 1983.

Petitioner's final and potentially most significant argument in favor of a separate section 1983 claim received but superficial treatment by the Colorado court. This was the claim that she was

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[58] 550 P.2d at 345.

[59] *See* Friendly, *In Praise of Erie - and the New Federal Common Law*, 39 N.Y.U. L. REV. 383 (1964). Among the areas where federal courts are developing a common law, Friendly lists interstate disputes, some national banking practices, government contract law, labor contract law, unfair competition, regulation of interstate carriers, and defamation by multi-state media. 39 N.Y.U. L. REV. 383, 408-18.

[60] 398 U.S. 375 (1970).

deprived of her own constitutional rights by the police shooting of her son. Although the court said these rights were not very well articulated, the issue was definitely before the court. The Colorado court stated that there was no deprivation of a constitutional right because the state did not directly attempt to restrict plaintiff's own personal decisions relating to procreation, contraception, and child rearing which were issues involved in cases such as *Griswold* v. *Connecticut*[61] and *Meyer v. Nebraska.*[62] The question thus presented was, what is the definition of a legally protectable liberty interest? The term "liberty," as contained in the due process clause of the fifth and fourteenth amendments, has been held to denote more than mere freedom from bodily restraint. It also guarantees the right of the individual to contract, to engage in any of the common occupations of life, to acquire useful knowledge, to marry, establish a home, *and to bring up children.*[63] The Court has clearly recognized the right to procreate;[64] *Jones* posited the question whether this right to conceive children could be expanded to give a mother the right to raise her child free from any wrongful taking by the state.

This specific question was addressed by the Eighth Circuit in a case which is strikingly similar to *Jones* on its facts, *Mattis v. Schnarr.*[65] In *Schnarr*, a father whose son had been shot and killed while attempting to escape arrest as a fleeing felon, brought a section 1983 action against the police officers who shot his son. The two cases differed, however, on the defenses asserted. In *Schnarr,* the defenses of good faith and probable cause were accepted by the district court and the action was dismissed. The court of appeals reversed the district court and held that although the defenses of good faith and probable cause were available to the officers in the action for damages, the father did have standing to bring a declaratory judgment action. The case turned on the issue of whether the plaintiff had standing to bring an action at all. The defendants relied, as did the Colorado court in *Jones,* on the argument that one may not sue for the deprivation of the

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[61] 381 U.S. 479 (1965).

[62] 262 U.S. 390 (1923).

[63] Board of Regents v. Roth, 408 U.S. 564 (1972); Skinner v. Oklahoma, 316 U.S. 535 (1942); Meyer v. Nebraska, 262 U.S. 290 (1923).

[64] Skinner v. Oklahoma, 316 U.S. 523 (1942).

[65] 502 F.2d 588 (8th Cir. 1974).

civil rights of another. The court established a two-step process by which it tested the plaintiff's standing in the action: (1) The party seeking relief must show that he is sufficiently affected by the action he is challenging to justify consideration by the court of the validity of the action; and (2) the plaintiff must show the action complained of affects him and not some third party.[66]

The court found that the father was sufficiently affected by the killing of his son to justify the court's considering the matter, reasoning that the state wrongful death statute created a vested right in the plaintiff to bring suit for the death of his minor son. The right was viewed as not being derivative, but rather, a new cause of action created in the father. The ground given for recovery was "the reciprocal duty of the child to render to its parents such services and earnings as the latter may reasonably expect."[67] The court quoted with approval a Missouri Supreme Court case which ruled that "the right of a parent to a minor's services is in the nature of a personal right arising out of the family relationship, not a property right arising out of a psuedo contractual relationship."[68]

In *Schnarr* the parent was found to be the "injured party" under section 1983, and was seen to be suing in his own right for injuries personally sustained.[69] This qualified him under the first of the court's two-part test for standing.

The court then turned to what it considered the more difficult question—whether the killing of plaintiff's son invaded his constitutionally protected rights under the due process clause of the fourteenth amendment. As most courts have done, the justices looked to see whether the interest was so deeply rooted in the traditions of Anglo-American law as to be considered fundamental. Citing *Meyer* and *Griswold,* the court focused on the familial relationship between parent and child and decided that such a relationship was indeed fundamental[70] and that the police

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[66] *Id.* at 593.

[67] *Id.*

[68] Mennemeyer v. Hart, 359 Mo. 423, 221 S.W.2d 960, 962 (1949) (quoted in Mattis v. Schnarr, 502 F.2d 588 (8th Cir. 1974)).

[69] 42 U.S.C. § 1983.

[70] "The entire fabric of the Constitution and its purposes that clearly underlie its specific guarantees demonstrate that the rights to marital privacy and to marry and *raise a family* are of similar order and magnitude as the fundamental rights specifically protected." Griswold v. Connecticut, 381 U.S. 479, 495-96 (1964).

officers did deny the plaintiff a civil liberty—the right to raise a son.

Schnarr was decided by the Eighth Circuit two years prior to the Colorado high court's review of *Jones*, yet it was not mentioned in the court's opinion.

V. The Review

At the time *Jones* was appealed to the United States Supreme Court, Colorado's position was clear: Section 1983 was silent on the issue of damages; section 1988 mandated resort to state law in such situations; Colorado's wrongful death statute was totally compatible with the purposes and objectives of section 1983; and thus it was totally controlling in both actions to the extent that the federal cause of action became a mere redundancy of the state redress. The Colorado court had ruled that merger was appropriate, that no section 1983 action exists independent of state law, that a survivor may not sue under section 1983 for injuries suffered by the deceased, and that any damages recoverable under section 1983 would be limited by Colorado law to direct pecuniary loss. As shown above, these rulings were contrary to those of a majority of the state and federal courts which had addressed these issues.

The case was ripe for review. The United States Supreme Court had not previously had an opportunity to address the issue as to what the appropriate measure of damages is in such an action. Additionally, the petitioner was arguing that the shooting of a child was a constitutional deprivation of a civil right protected by the liberty clause of the fourteenth amendment. This issue also had never been addressed by the nation's highest court.

It appeared that the case would turn upon a discussion of two issues: (1) A *Davis* type discussion as to what is or what is not a valid protectable liberty interest; and (2) whether or not a state's net pecuniary loss rule is consistent with the purposes of the Civil Rights Act?

Unfortunately, the court declined to discuss these important issues. Instead the justices split 5-3 (one justice not hearing the case) as to what had actually been presented to the Colorado court. Five justices, as stated in their per curiam opinion, believed that there had been a shift in the posture of the case upon appeal. These justices ruled that the question presented in the petition for certiorari had been mooted by petitioner's oral argument. Thus the writ of certiorari was dismissed as being "improvidently granted."[71]

The rationale given by the Court for the dismissal was that they had granted certiorari to look at the issue of damages; that is, to see if the Colorado state limitation was proper in the section 1983 action. A necessary prerequisite for this review, as stated by the Court, was that the plaintiff must be suing for the *same injury* under section 1983 as he is under the state wrongful death statute. The Court reasoned that this situation could not exist if the damages sought under section 1983 were for injuries to a different plaintiff than the one allegedly wronged under the state statute. The majority argued that petitioner had shifted her case to a different wrong upon oral argument—the deprivation of the mother's right to raise her child without interference. Citing the Colorado position that wrongful death is only a property tort action, not an action for injuries to the person, the Court said that the two actions were clearly distinct.[72]

Justices White, Brennan, and Marshall, however, felt that the question of a mother's deprivation of a constitutionally protected right had been sufficiently raised in the Colorado Supreme Court. These justices believed that the issues were important and should have been decided. In support of their position, they pointed to the Colorado court's specific rejection of each of petitioner's claims in support of her 1983 action, specifically the fourth claim where she alleged violation of her own constitutional rights. The minority cited the allegations made in petitioner's original complaint which clearly could be read so as to include a claim for invasion of the mother's own civil liberties.[73] In the

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[71] 97 S. Ct. 2283 (1977). The Court cited Supreme Court Rule 23(1)(c) and Belcher v. Stengel, 429 U.S. 118 (1926), as authority for the dismissal.

[72] Fish v. Liley, 120 Colo. 156, 28 P.2d 930 (1949).

[73] Both the per curiam and the minority opinions cited portions of petitioner's complaint as authority for their respective positions as to what had actually been set forth below. The majority cited a somewhat edited version of petitioner's third claim (the section 1983 claim) to support their contention that a case for the deprivation of the mother's civil rights had not been sufficiently made. The majority opinion, in contrast, quoted the third claim in full. This claim taken in full context clearly may be read as to include a definite constitutional claim for the deprivation of the petitioner's own civil rights.

A comparison of the two footnotes is set forth below:

Per Curiam note six:

6. Her complaint alleged that *she* was deprived of:
"a. Her child's right to life

words of Justice White, "[t]hese issues were addressed directly by the Colorado Supreme Court, and I doubt that that court misunderstood the scope of the litigation before it or reached and decided issues not fairly presented by the appeal."[74]

The minority opinion added that, in addition to the question of whether a mother's civil liberties included the right to raise a son free from state interference, the question of the state damage limitation was also a valid question for review.

Conclusion

As it now stands in Colorado, state damage limitations appear to control federal actions brought in state court in conjunction with state statutory claims. This is in spite of an express overruling of the Colorado decision by a minority of the United States Supreme Court and a definite effort to avoid endorsement of the decision by a majority of the justices.

The situation in Colorado at present is that the *Jones* decision stands as a very weak precedent for future plaintiffs. The results of the decision might be attacked on one of several grounds. First, a future plaintiff will be careful to sue in behalf of the estate of the deceased to avoid any problems with the issue of standing. Once standing is firmly established, a direct attack on the damage issue may be launched by showing the incompatibility of the state net pecuniary loss rule with the aims and purposes of the federal Civil Rights Act. Section 1988 does not re-

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"b. The right to her child's freedom from physical abuse, coercion, intimidation, and physical death; and

"c. Her right to her children's equal protection of the laws."

Nowhere does she allege her asserted constitutional right to raise her child.

97 S. Ct. 2283, 2286 n.6 (1977).

Justice White's note two:

2. Petitioner's first two claims for relief were grounded on state law. The third claim for relief stated:

"During all times mentioned in this Complaint, Douglas Hildebrant while acting under color of law, *intentionally deprived the Plaintiff of her rights, security and liberty secured to her by the Constitution of the United States, including but not limited to:*

"a. Her child's right to life;

"b. The right to her child's freedom from physical abuse, coercion, intimidation, and physical death; and

"c. Her right to her children's equal protection of the law." App. 3. (emphasis added).

97 S. Ct. 2283, 2288, n.2 (1977).

[74] 97 S. Ct. at 2290.

quire the incorporation of such inconsistent provisions. The Supreme Court has left open for future decisions the evaluation of a mother's rights in the raising of a child. Clearly a *Schnarr*-type argument could be made that the right to raise a child free from state interference is a fundamentally protected civil liberty.

In any case, the failure of the Colorado courts to fairly address these issues in the light of recent case law and the hesitancy of a majority of the United States Supreme Court to address the liberty issue has done much to confuse and little to clarify state-federal relationships in the context of section 1983 actions.[75]

Bruce A. Lampert

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[75] The fact that the issues presented in *Jones* have merely been postponed and not resolved is exemplified by a recent filing in the Colorado District Court. Walter Gerash, one of the attorneys for the petitioner in *Jones,* has been retained by the survivors of Arthur Espinoza, a victim of a July 30th shooting in Curtis Park by a Denver policeman. The issues presented in *Jones* have again been raised.

In his pleadings Mr. Gerash has not filed a wrongful death action at all, but rather he has filed only a section 1983 claim. In addition, the action is being brought in the name of the estate of Mr. Espinoza, pleading deprivation of his constitutional rights as well as those of his family. The validity of the Colorado decision in *Jones* will be tested shortly.

THE POWER TO REGULATE PEOPLE: *Moore v. City of East Cleveland*

INTRODUCTION

The Village of Euclid and the City of East Cleveland are adjacent suburban coumunities located northeast of Cleveland. Both Euclid and East Cleveland passed zoning ordinances which when challenged as constitutionally invalid became the subjects of review and decision by the United States Supreme Court.[1]

The two decisions, *Village of Euclid v. Ambler Realty Co.*[2] and *Moore v. City of East Cleveland,*[3] were handed down more than fifty years apart, and they represent two of the four times[4] the Supreme Court has spoken out on the power of municipalities to regulate land use through zoning.[5]

A subtle but significant change has taken place in the zoning powers of municipalities during the span of years between *Euclid* and *Moore:* What began in 1926 as the power to regulate the uses of land[6] has expanded in 1977 to include the power to regulate the people who use the land.[7]

The analysis of this evolution will be in three parts: First, a brief summary of the two cases which gave rise to the new power, *Village of Belle Terre v. Boraas*[8] and *Moore*; second, a discussion

[1] Moore v City of East Cleveland, 431 U.S. 494 (1977); Village of Euclid v. Ambler Realty Co., 272 U.S. 365 (1926).

[2] 272 U.S. 365 (1926).

[3] 431 U.S. 494 (1977).

[4] Moore v. City of East Cleveland, 431 U.S. 494 (1977); Village of Belle Terre v. Boraas, 416 U.S. 1 (1974); Nectow v. City of Cambridge, 277 U.S. 183 (1928); Village of Euclid v. Ambler Realty Co., 272 U.S. 365 (1926).

[5] Three other Supreme Court cases in the 1970's interpret zoning ordinances, without tracing the origins of zoning power back to *Euclid.* Village of Arlington Hts. v. Metropolitan Hous. Dev. Corp., 429 U.S. 252 (1977); Young v. American Mini Theaters, Inc., 427 U.S. 50 (1976); City of Eastlake v. Forest City Enterprises, 426 U.S. 668 (1976).

[6] Village of Euclid v. Ambler Realty Co., 272 U.S. 365 (1926). The Court in *Euclid* upheld a complex zoning scheme which divided the village into various classes of use districts, ranging from single family dwellings to heavy industrial uses. *Id.* at 389-91.

[7] Moore v. City of East Cleveland, 431 U.S. 494 (1977); Village of Belle Terre v. Boraas, 416 U.S. 1 (1974). *See* Frame & Scorza, Village of Belle Terre v. Boraas: *Property Rights, Personal Rights & the Liberal Regime,* 2 HASTINGS CONST. L.Q. 935 (1975); Note, *An Extension of the State's Police Power: The Protection of Family Values Through Zoning Litigation,* 21 LOY. L. REV. 243 (1975).

[8] 416 U.S. 1 (1974).

of the confines of the so-called "two-tier" equal protection analysis which led to *Belle Terre;* and third, an analysis of *Moore* as a response to *Belle Terre.*

I. THE CASES

A. Belle Terre

The Village of Belle Terre passed an ordinance restricting land use to single-family dwellings, defining "family" to include one or more persons related by blood, adoption, or marriage, or not more than two unrelated persons living as a single housekeeping unit.[9] The owners of a house in Belle Terre leased it to six unrelated students. When notified that they were in violation of the ordinance, the owners and three of the students sought to have the ordinance declared unconstitutional.[10] The district court sustained the ordinance,[11] but the court of appeals struck down the ordinance as violative of equal protection.[12]

The Supreme Court reversed, using an equal protection analysis: Since the ordinance did not infringe on any fundamental right it was to be given only a minimum level of scrutiny.[13] Justice Douglas,[14] writing for the majority, cursorily dismissed the contention that the ordinance encroached on any "fundamental right" guaranteed by the Constitution.[15] Rather, the opinion em-

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[9] *Id.* at 2.

[10] *Id.* at 2-3.

[11] 367 F. Supp. 136, 148-49 (E.D.N.Y. 1973).

[12] 476 F.2d 806, 818 (2d Cir. 1973). The court of appeals had departed from the traditional "two-tier" analysis. *See* Gunther, *The Supreme Court 1971 Term—Foreword: In Search of Evolving Doctrine on a Changing Court: A Model for a Newer Equal Protection,* 86 HARV. L. REV. 1 (1972) [hereinafter Gunther], asking instead "whether the legislative classification is in fact substantially related to the object of the statute." Boraas v. Village of Belle Terre, 476 F.2d 806, 814 (2d Cir. 1973).

[13] The Court used the so-called "two-tier" approach. *See* notes 43-75 *infra.*

[14] Many people had expected Douglas to classify the choice of household living companions as a civil liberty not to be interfered with by the state, especially considering his concurring opinion one year earlier in Department of Agriculture v. Moreno, 413 U.S. 528, 543 (1973). Criticism of the apparent inconsistency between his views in *Moreno* and *Belle Terre* has been strong. *See* Village of Belle Terre v. Boraas, 416 U.S. 1, 17-18 (Marshall, J., dissenting); Margolis, *Exclusionary Zoning: For Whom Does Belle Terre Toll,* 11 CALIF. W.L. REV. 85 (1974); Note, *No Dogs, Cats or Voluntary Families Allowed,* 24 DEPAUL L. REV. 784 (1975).

[15] 416 U.S. at 7-8. The "fundamental rights" which have been held to trigger strict scrutiny are: The right to travel, Shapiro v. Thompson, 394 U.S. 618 (1969); the right to vote, Harper v. Virginia Bd. of Elections, 383 U.S. 663 (1966); the right of association, NAACP v. Alabama, 357 U.S. 449 (1958); the right of access to courts, NAACP v. Button,

phasized the wide latitude given to the state in its exercise of police power:[16] "It is ample to lay out zones where family values, youth values, and the blessings of quiet seclusion and clean air make the area a sanctuary for people."[17]

Justice Marshall dissented,[18] stating that the classification distinguishing related and unrelated people "burden[ed] the students' fundamental rights of association and privacy guaranteed by the First and Fourteenth Amendments."[19] The judicial deference generally given to legislative determinations did not require abdication of judicial responsibility to protect basic constitutional rights.[20] By attempting to regulate "the way people choose to associate with each other within the privacy of their own homes,"[21] Belle Terre had unconstitutionally interfered with fundamental rights.

B. Moore

Belle Terre appeared to be conclusive: Broad judicial deference must be given to local zoning officials in the exercise of their police power, and that power includes the power to regulate the internal composition of the household.

Three years later, however, the Court tempered its *Belle Terre* holding in *Moore v. City of East Cleveland.*[22] Petitioner Inez Moore lived with her son and two grandchildren. The grandchildren were first cousins rather than brothers, one being the child of her son and the other the child of her deceased daughter.[23] Because of the city's definition of "family" in its single-family zoning ordinance,[24] Mrs. Moore was notified that one of her grandchildren was an "illegal occupant." When she refused to

371 U.S. 415 (1963); the right to procreate, Skinner v. Oklahoma, 316 U.S. 535 (1942); the right of privacy, Roe v. Wade, 410 U.S. 113 (1973), and Griswold v. Connecticut, 381 U.S. 479 (1965).

[16] *See* Berman v. Parker, 348 U.S. 26 (1954).

[17] 416 U.S. at 9.

[18] *Id.* at 12 (Marshall, J., dissenting).

[19] *Id.* at 13. The fundamental rights of association and privacy are included in note 15 *supra.*

[20] 416 U.S. at 13-14.

[21] *Id.* at 17.

[22] 431 U.S. 494 (1977).

[23] *Id.* at 496-97.

[24] The East Cleveland ordinance defined "family" members by their relation to the nominal head of the household. The complex provision is found at 431 U.S. 496 n.2.

remove the child, Mrs. Moore was convicted of violating the ordinance.[25] On appeal she challenged its constitutionality.

East Cleveland's ordinance, and Mrs. Moore's claim of invalidity, were substantially similar to the ordinance and claim the Court had reviewed three years earlier in *Belle Terre.* Both ordinances dealt with single-family zones, and attempted to define "family" in a restrictive fashion. Both purported to serve traditional zoning objectives: Preventing overcrowding, minimizing traffic and parking congestion, preserving a neighborhood free of disturbing noises.[26] Both ordinances recognized the importance of the "family."[27] Most importantly, both ordinances went beyond the traditional scope of zoning set forth in *Euclid,*[28] regulating the *use* of land, and sought to regulate *who* may use the land and in what manner.[29]

Despite some similarity, the Court chose to distinguish *Belle Terre* by creating a new fundamental right of "family" and by using substantive due process analysis instead of equal protection analysis.

The Court, Justice Powell writing for the majority, began by describing the effect of East Cleveland's ordinance. Unlike Belle Terre, East Cleveland had attempted to regulate its housing by slicing deeply into the family itself: "On its face, [the East Cleveland ordinance] selects certain categories of relatives who may live together and declares that others may not. In particular, it makes a crime of a grandmother's choice to live with her grandson . . . ."[30] The opinion then discussed the constitutional issue of the case: whether the ordinance violated the due process clause of the fourteenth amendment.[31] The usual rule of judicial deference to legislative discretion was inappropriate here because the

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[25] *Id.* at 497.

[26] *Id.* at 499-500; Village of Belle Terre v. Boraas, 416 U.S. at 5, 9.

[27] Belle Terre sought to protect the "extended family," while East Cleveland provided protection to the "nuclear family." *See* Moore v. City of East Cleveland, 431 U.S. at 507-510 (Brennan, J., concurring).

[28] 272 U.S. 365, 387 (1926). *See* note 6 *supra.*

[29] Only Justice Stevens perceived the distinction. He saw the critical issue as the extent to which courts should allow interference with a property owner's right to determine the internal composition of his household. 431 U.S. 494, 518-19 (Stevens, J., concurring).

[30] *Id.* at 498-99.

[31] The Court found it unnecessary to reach Mrs. Moore's contention that the ordinance was violative of the equal protection clause. *Id.* at 496 n.3.

legislature had intruded on the freedom of choice in matters of marriage and family life.[32] Justice Powell noted that the Court had consistently recognized some private realm of family life which the state would not be allowed to penetrate.[33] Governmental intrusion into this realm was subject to strict judicial scrutiny.[34] The Court ruled that when such scrutiny was applied, the ordinance had to fall because the governmental interests advanced were not sufficient to justify the city's intrusion on a fundamental right.[35]

Justice Powell clearly recognized the need for "caution and restraint" whenever the Court proceeded to review legislation on substantive due process grounds. The pitfalls of the *Lochner*[36] years, when the Court took on powers of judicial intervention as a "super-legislature,"[37] served as a warning to courts that intervention must be exercised with great care.[38] But judicial interference was appropriate, even essential, when government impinged on "the sanctity of the family."[39]

Justices Brennan, Marshall, and Blackmun joined Justice Powell's majority opinion.[40] Justice Stevens gave the Court its bare majority in striking down the ordinance, but he concurred only in the judgment, not in the opinion of the majority.[41]

The four dissenting Justices filed three separate opinions

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[32] *Id.* at 499.

[33] *Id.* The Court listed numerous cases in support of the "private family realm," though none of the cases had specified any definitive boundaries of that realm. *Id.*

[34] *Id.*

[35] *Id.* at 499-500. East Cleveland had attempted to justify the ordinance as a measure designed to alleviate overcrowding and undue financial burdening of its school system. The Court ruled that the particular ordinance before the Court had but a tenuous relation to alleviation of those problems. *Id.*

[36] Lochner v. New York, 198 U.S. 45 (1904). *See* text accompanying notes 43-45 *infra.*

[37] The terminology is taken from Griswold v. Connecticut, 381 U.S. 479 (1964), wherein the Court refused to use *Lochner* as a guide. *Id.* at 482.

[38] "[T]here is reason for concern lest the only limits to such judicial intervention become the predilections of those who happen at the time to be Members of the Court." Moore v. City of East Cleveland, 431 U.S. at 502.

[39] *Id.* at 503.

[40] *Id.* at 506 (Brennan, J., concurring).

[41] *Id.* at 513. (Stevens, J., concurring). Justice Stevens rested his opinion on procedural due process: "[T]here [does not] appear to be any justification for such a restriction on an owner's use of his property . . . . East Cleveland's unprecedented ordinance constitutes a taking of property without due process and without just compensation." *Id.* at 520-21.

with varying reasons for their disagreement.[42]

II. The Confines of the Two-Tier Analysis

A. *Development of and Difficulties with the Two-Tier Approach*

Around the turn of the century, a series of cases culminating in *Lochner v. New York*[43] had established a policy of judicial intervention on substantive due process grounds.[44] This policy, in reality a substitution of judicial notions of public policy for legislative choices, was gradually abandoned in the 1930's.[45] During the years of the Warren Court, however, intervention by the Court regained limited acceptance. This time, rather than relying on the due process clause, the Court began to use equal protection analysis in examining state legislation. Whenever a legislative classification impinged on a "fundamental right" or involved a "suspect classification," that legislation was subjected to strict scrutiny by the Court and was struck down unless the state could offer a compelling state interest to overcome its constitutional frailty. The list of fundamental rights and suspect classifications was finite,[46] but application of the high level of scrutiny was virtually always fatal.[47] Though never formally adopted by the Court,[48] the "two-tier" analysis, strict versus minimal scrutiny, became the standard of the Warren Court.[49]

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[42] Chief Justice Burger dissented on procedural grounds—Mrs. Moore's failure to exhaust her administrative remedies. *Id.* at 521. Justices Stewart and Rehnquist viewed *Belle Terre* as controlling on most issues, and they dissented primarily because of their belief that the Court possessed limited powers of intervention. *Id.* at 531-35. Justice White disagreed with the Court's use of substantive due process. *Id.* at 541.

[43] 198 U.S. 45 (1904).

[44] *See generally*, G. GUNTHER, CASES & MATERIALS ON CONSTITUTIONAL LAW 548-656 (1975).

[45] *See* West Coast Hotel v. Parrish, 300 U.S. 379 (1937); Nebbia v. New York, 291 U.S. 502 (1934).

[46] For a general list of fundamental rights, see note 15 *supra*. The most common suspect classifications triggering strict scrutiny are: Race, Loving v. Virginia, 388 U.S. 1 (1967); alienage, Graham v. Richardson, 403 U.S. 365 (1971), and Yick Wo v. Hopkins, 118 U.S. 356 (1886); and national origin, Oyama v. California, 332 U.S. 633 (1948).

[47] The one notable exception is Korematsu v. United States, 323 U.S. 214 (1944) (national security upheld as a compelling state interest for the confinement of Japanese during World War II).

[48] *See* Note, *Equal Protection: Modes of Analysis in the Burger Court*, 53 DEN. L.J. 687 n.1 (1976) [hereinafter cited as *Modes of Analysis in the Burger Court*].

[49] The approach of the Court in Shapiro v. Thompson, 394 U.S. 618 (1969), is illustrative of the two-tier analysis. In *Shapiro*, the Court invalidated three state laws which defined welfare benefits to persons not meeting the one-year residency requirement, stating:

Difficulties inherent in the two-tier system soon became apparent.[50] On the one hand, application of the two-tier approach seemed straightforward: Interference with a fundamental right or suspect class would not be tolerated, and the statute would be stricken; absent such interference, the statute would be upheld.[51] On the other hand, the enumerated fundamental rights were so imprecise that it was difficult to discern when legislation infringed on a fundamental right. Therefore, the Court was able to intervene freely and strike down statutes merely by spinning analogies to previously enumerated rights.[52] Dissatisfaction with the two-tier approach grew in the Supreme Court, expressed most vocally by Justice Marshall.[53]

The Burger Court seemed to move away from the rigidity of the two-tier system toward an intermediate standard of scrutiny. Some decisions of the early seventies marked an apparent change. In *Weber v. Aetna Casualty & Surety Co.*,[54] for example, the Court invalidated a Louisiana workman's compensation statute which denied recovery to an illegitimate child, stating: "[W]hen some statutory classifications approach sensitive and fundamental personal rights, this Court exercises a stricter scrutiny . . . . The essential inquiry in all [these] cases is . . . : What legitimate state interest does the classification promote? What fundamental personal rights might the classification endanger?"[55]

While a *Weber*-type approach was followed in a subsequent decision in the same year,[56] it was never accepted as a replace-

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> [W]e reject appellant's argument that a mere showing of a rational relationship between the waiting period and . . . permissible state objectives will suffice to justify the classification . . . [A]ppellees were exercising [their] constitutional right [to travel], and any classification which serves to penalize the exercise of that right, unless shown to be necessary to promote a *compelling* governmental interest, is unconstitutional.

Id. at 634 (citations omitted).

[50] An exhaustive treatment of the "two-tier" approach and its vagaries is contained in Note, *Developments—Equal Protection*, 82 HARV. L. REV. 1065, 1123-24 (1969).

[51] *See* text accompanying notes 46-47 *supra*.

[52] *See* Gunther, *supra* note 12, at 10.

[53] *See* San Antonio Indep. School Dist. v. Rodriquez, 411 U.S. 1, 97-130 (1972) (Marshall, J., dissenting); Dandridge v. Williams, 397 U.S. 471, 520-21 (Marshall, J., dissenting).

[54] 406 U.S. 164 (1972).

[55] *Id.* at 172-73.

[56] Police Dept. of Chicago v. Mosley, 408 U.S. 92 (1972).

ment of the two-tier system. On the contrary, there were divergent views as to which standard the Court might apply in future cases. One commentator forecast the arrival of a "means-oriented" approach;[57] Justice Marshall advocated a "sliding-scale" approach.[58] But none of these was ever formally adopted by the Court.[59]

B. Belle Terre *and the Two-Tier Approach*

1. Background

In the absence of Supreme Court guidance in the zoning area,[60] courts addressing precisely the same issue—the extent to which a local zoning ordinance may interfere with the choice of household companions—handed down conflicting decisions using different constitutional rationales.[61]

A New Jersey court struck down a zoning ordinance with a restrictive definition of "family" on substantive due process grounds.[62] A federal court in Wisconsin struck down a similar statute using equal proteciion analysis and an intermediate standard of scrutiny.[63] An Illinois court ignored constitutional issues altogether, ruling that the legislature was not authorized to pass a zoning ordinance which regulated the internal composition of households.[64] And finally, a federal court in California upheld a restrictive definition of "family" after deciding that neither equal protection nor due process applied.[65]

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[57] Gunther, *supra* note 12, at 20-21.

[58] *See* San Antonio Indep. School Dist. v. Rodriquez, 411 U.S. 1, 98-99 (1972) (Marshall, J., dissenting).

[59] *See Modes of Analysis in the Burger Court, supra* note 48, at 716.

[60] *See* text accompanying notes 1-7 *supra.*

[61] *See, e.g.*, Boraas v. Village of Belle Terre, 476 F.2d 806 (2d Cir. 1973). The dearth of Supreme Court zoning cases provided the judge with little guidance as to the Burger Court's approach to equal protection analysis. It was unclear whether minimum or strict scrutiny or some intermediate standard should be applied. *See* text accompanying notes 50-59 *supra.* His decision upholding the ordinance relied on similar state cases and his belief that the Burger Court had an intermediate standard of scrutiny—both were grounds for Supreme Court reversal. *See* text accompanying notes 9-21 *supra.*

[62] Kirsch Holding Co. v. Borough of Manasquan, 59 N.J. 241, 251-52, 281 A.2d 513, 518 (1971).

[63] Timberlake v. Kenkel, 369 F. Supp. 456 (E.D. Wis. 1974).

[64] City of Des Plaines v. Trottner, 34 Ill. 2d 432, 438, 216 N.E.2d 116, 120 (1966).

[65] Palo Alto Tenants Union v. Morgan, 321 F. Supp. 908 (N.D. Cal. 1970), *aff'd,* 487 F.2d 883 (9th Cir. 1973), *cert. denied,* 417 U.S. 910 (1974).

2. *Belle Terre*

The court of appeals opinion in *Belle Terre*[66] represented the Second Circuit's attempt to find the appropriate constitutional standard for examining restrictive definitions of family. The court's inquiry was limited to whether the zoning ordinance's unequal classification—allowing occupancy to more than two members of a traditional family while denying occupancy to a "voluntary" family—[67] violated the equal protection clause.

After deciding that the traditional "fundamental" rights were not affected and therefore strict scrutiny was inappropriate,[68] the court ruled that it was not limited by the rigidity of the two-tier formula: "[T]he Supreme Court appears to have moved from this rigid dichotomy . . . toward a more flexible and equitable approach . . . . Under this approach the test for application of the Equal Protection Clause is whether the legislative classification is *in fact* substantially related to the object of the statute."[69] This ordinance had the purpose and effect of compelling Belle Terre residents to conform to the community's prevailing social preferences; as such, the ordinance had no relevance to the public health, safety, or welfare, and was thus invalid.[70]

The Supreme Court's reversal of the court of appeals had a two-fold effect. First, the Court did what the court of appeals said was not possible: It justified the restrictive ordinance under the traditional zoning objectives.[71] The Supreme Court expanded the concept of the general welfare to include the power to promote family values.[72]

Second, *Belle Terre* confirmed the application of the "two-tier" approach in zoning cases, and rejected the court of appeals'

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[66] Boraas v. Village of Belle Terre, 476 F.2d 806 (2d Cir. 1973).

[67] *Id.* at 812.

[68] *Id.* at 813-14. The court acknowledged that the rights of privacy, association, and travel asserted by the plaintiffs were important, but that they did not "fit snugly" into any of the Supreme Court's previously recognized categories of fundamental rights. *Id.* at 814.

[69] *Id.* at 814 (footnotes omitted).

[70] *Id.* at 815.

[71] *See* Note, *The Entrenchment of the Traditional Family Structure*, 13 J. FAM. L. 901, 905 (1973-74).

[72] *Belle Terre*, 416 U.S. at 9. *See also* Note, Village of Belle Terre v. Boraas—*A Reaffirmation & Strengthening of the Police Power*, 4 CAP. U.L. REV. 157, 164 (1974) [hereinafter cited as *Strengthening of the Police Power*].

choice of an intermediate, flexible level of scrutiny.[73] Justice Douglas' review was brief and conclusive: No fundamental rights were involved, nor was the ordinance aimed at transients.[74] Such a restrictive definition of family was permissible within the exercise of the police power.[75] In short, strict scrutiny would be applied only to ordinances infringing on previously enumerated fundamental rights, and these rights would be strictly construed; minimal scrutiny would be the standard for all other ordinances.

III. *Moore:* RESPONDING TO *Belle Terre*

The inflexibility of the "two-tier" approach, specifically adopted in the zoning area by the Supreme Court, became apparent in *Moore.* The injustice of an ordinance which "makes a crime of a grandmother's choice to live with her grandson"[76] was clear enough, but the Court had confined itself to an either-or choice: Either find a fundamental right triggering strict scrutiny and force the government to show a compelling state interest justifying the ordinance, or allow the injustice to remain after a minimal amount of scrutiny.

Belle Terre had established a strong precedent, the application of minimum scrutiny of zoning cases. In *Moore,* the Supreme Court was forced to use two techniques to circumvent the constraints of its earlier decision. First, the Court avoided equal protection altogether, resting its decision within the contours of substantive due process.[77] The Court offered no explanation for its choice of due process instead of equal protection, but it seemed to take comfort in the imprecision of the due process clause itself. The Court quoted at length from Justice Harlan's dissent in *Poe v. Ullman,*[78] including:

> [T]he full scope of the liberty guaranteed by the Due Process Clause cannot be found in or limited by the precise terms of the specific guarantees elsewhere provided in the Constitution. This "liberty" . . . is a rational continuum which recognizes what a reasonable and sensitive judgment must, that certain interests require

[73] *See Strengthening of the Police Power, supra* note 72, at 164.
[74] 416 U.S. at 7-8.
[75] *See* text accompanying notes 16-17 *supra.*
[76] Moore v. City of East Cleveland, 431 U.S. at 499.
[77] *Id.* at 496 n.3.
[78] 367 U.S. 497 (1961) (Harlan, J., dissenting).

particularly careful scrutiny of the state needs asserted to justify their abridgment.[79]

The Court recognized that its decision marked a reentry into the treacherous field of substantive due process,[80] but the Court's hesitance would not override its duty to strike down an arbitrary cutting off of protected family rights.[81]

A second and more significant way that the Court avoided its *Belle Terre* reasoning was by creating a new fundamental right, the right of family for related individuals.[82] Plaintiffs in *Belle Terre* had unsuccessfully claimed that the Village's ordinance infringed on their fundamental right of privacy, association, and travel.[83] For the Supreme Court in *Moore* to return to any of these rights as a means of invoking strict scrutiny would have been difficult without overruling, or at least emasculating *Belle Terre.*

Though it is too early to forecast the effect of the Court's resurrection of substantive due process, the Court's creation of a new fundamental right is likely to have several immediate and possibly profound consequences. Specifically, two issues have been raised by *Moore:* First, how can local zoning authorities reconcile the two Supreme Court holdings, *Moore* and *Belle Terre,* in drafting future single-family ordinances? And second, what are the perimeters of the newly established right of family?

A. *Reconciliation*

At first blush, reconciliation of the two decisions seems fairly straightforward. Justice Powell's majority opinion saw *Belle Terre* as distinguishable from *Moore.*[84] The *Belle Terre* ordinance made a clear cut and reasonable distinction between related and unrelated people, and it purported to promote "family needs" and "family values."[85] East Cleveland's ordinance on the other hand, made no such rational distinction; the city's scheme arbitrarily "selects certain categories of relatives who may live together and declares that others may not."[86]

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[79] *Id.* at 542-43, quoted in Moore v. City of East Cleveland, 431 U.S. at 499.

[80] *See* text accompanying notes 47-50 *supra.*

[81] 431 U.S. at 502.

[82] *See* text accompanying notes 36-38 *supra.*

[83] *See* text accompanying note 74 *supra.*

[84] 431 U.S. at 498.

[85] Village of Belle Terre v. Boraas, 416 U.S. at 9.

[86] Moore v. City of East Cleveland, 431 U.S. at 498-99.

The distinction between the two cases was clear especially in light of the different plaintiffs in each case: Six college students with no familial ties in *Belle Terre*;[87] a grandmother separated from her orphaned grandchild in *Moore*.[88] The clarity of the related-unrelated distinction begins to fade, however, when the contrast between potential plaintiffs is not so extreme. Justice Marshall summarized the possibly absurd results under a blood-relation requirement, questioning the validity of an ordinance which "permits any number of persons related by blood or marriage, be it two or twenty, to live in a single household," but which limits "the number of unrelated persons bound by profession, love, friendship, religious or political affiliation, or mere economics who can occupy a single home."[89]

The majority opinion's failing in *Moore* is that it gives no guidance to the lower courts for future cases. If the related-unrelated test is carried to its extreme, a single-family ordinance might limit the number of unrelated individuals to one person.[90] At the other extreme, *Moore* might be interpreted to mean that municipalities may place no limits whatsoever on the number of related individuals, thus defeating the traditional purposes of zoning.[91]

Three other views offered by the Justices in *Moore* further confuse future applications of both *Moore* and *Belle Terre*.

Justice Brennan's concurring opinion perceived *Belle Terre* as supportive of the Court's holding rather than distinguishable from it.[92] The *Belle Terre* ordinance had extended protection to all related people; the Village knew it was powerless to interfere with families of related individuals. East Cleveland had extended protection only to nuclear families despite the existence of "extended" families, especially among blacks.[93] As such, the ordi-

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87 Village of Belle Terre v. Boraas, 416 U.S. at 2.

88 Moore v. City of East Cleveland, 431 U.S. at 496-97.

89 Village of Belle Terre v. Boraas, 416 U.S. at 16 (Marshall, J., dissenting).

90 *But see* Department of Agriculture v. Moreno, 413 U.S. 528 (1973).

91 *See* note 35 *supra*. The obvious extension of the Court's holding is that no legislation may interfere with the family, no matter now large the family is, how many cars the family possesses, or how many children from the family enter the school system. *See, e.g.*, Riverside v. Reagan, 270 Ill. App. 355 (1933) (eighteen related individuals *held* to be a single family).

92 431 U.S. 494, 511 (Brennan, J., concurring).

93 *Id.* at 508-510.

nance represented an "imposition by government upon the rest of us of white suburbia's preference in patterns of family living."[94]

Justice Brennan's view of *Belle Terre* suffers the same weakness that the majority view does: Under the *Moore-Belle Terre* combination, a city is powerless to regulate the number of people allowed in single-family dewellings if they are related, but the city may regulate the lifestyle choices of unrelated individuals, with no apparent limitations.

Justice Stevens, concurring only in the judgment, offered a third view of *Belle Terre.*[95] His actual interpretation of *Belle Terre* is contained only in a footnote,[96] and it is far from clear what significance he attached to *Belle Terre* as precedent. Justice Stevens stated that ordinances regulating the internal composition of households, like the Belle Terre ordinance, were permissible only if aimed at preventing transiency,[97] despite the fact that his predecessor Justice Douglas specifically ruled that the ordinance was *not* aimed at transients.[98] Justice Stevens' interpretation of *Belle Terre* can mean only that he would have decided *Belle Terre* differently if the city had been unable to prove the effectiveness of its ordinance in preventing transiency. Justice Stevens' basic premise was that a property owner, not the city, has a fundamental right to decide who may reside on the property.[99]

The fourth and final interpretation of *Belle Terre* is contained in Justice Stewart's dissent.[100] Justice Stewart described *Belle Terre* as controlling on Mrs. Moore's claimed rights of association and "privacy of the home."[101] While he recognized the distinction between related and unrelated persons, Justice Stewart stated that the mere existence of ties of kinship did not give related persons constitutional protection superior to that given to unrelated persons.[102] Like the other views of *Belle Terre,* Justice Stewart's opinion offers little guidance as to what extent future zoning ordinances may regulate the internal composition of households.

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[94] *Id.* at 508.
[95] *Id.* at 513 (Stevens, J., concurring).
[96] *Id.* at 519 n.15.
[97] *Id.* at 519.
[98] Village of Belle Terre v. Boraas, 416 U.S. at 7.
[99] Moore v. City of East Cleveland, 431 U.S. at 513-14.
[100] *Id.* at 531 (Stewart, J., dissenting).
[101] *Id.* at 535.
[102] *Id.*

Thus, *Moore* presented four disparate views of *Belle Terre.* Reconciliation of the two cases by local authorities and their subsequent application may prove difficult. Taken to extremes, *Belle Terre* would allow the exclusion of all unrelated individuals, while *Moore* would not allow any numerical limitation on related individuals. Should the Court now decide to step out of the zoning arena, as it did for fifty years after *Euclid,*[103] forcing the states to determine what *Belle Terre* and *Moore* really mean, confusion may be the end result.

B. *The Perimeters of the Family Right*

Zoning laws encompass a great variety of definitions of family.[104] The fact that zoning laws should be concerned with families at all is somewhat paradoxical, since zoning was originally upheld as a means of regulating uses of land[105] without regard to *who* uses the land or in what manner.[106]

Municipal definitions of "family" became inevitable when zoning ordinances began to set aside certain zones for single-family dewellings. Having upheld the power to zone, the Supreme Court initially declined to enter the definitional controversies that arose in lower courts.[107] The Supreme Court intervened only when local governments began to differ on the extent to which they could regulate who constituted a single "family" under their ordinances.

The decision in *Moore* represents the second step of the Supreme Court's review of permissible "families" which it began three years earlier in *Belle Terre.* Though the *Moore* majority attempted to distinguish the prior case, *Moore* is really a corollary to the *Belle Terre* holding: Zoning to *protect* the family and

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[103] 272 U.S. 365 (1926). *See* text accompanying notes 1-7 *supra.*

[104] *See, e.g.,* Village of Belle Terre v. Boraas, 416 U.S. 1 (1974) ("family" defined as two unrelated people or more than two people related by blood, marriage, or adoption); Neptune Park Ass'n v. Steinberg, 138 Conn. 357, 84 A.2d 687 (1951) ("family" defined as a single housekeeping unit); People v. Skidmore, 69 Misc. 2d 320, 329 N.Y.S.2d 881 (1971) ("family" defined as one or more persons occupying a unit as a non-profit housekeeping unit).

[105] Village of Euclid v. Ambler Realty Co., 272 U.S. 365 (1926).

[106] *See* text accompanying notes 1-7 *supra.*

[107] After *Euclid* and *Nectow, see* text accompanying notes 1-7 *supra,* the Court specifically denied certiorari on several occasions. *See* Lionshead Lake, Inc. v. Township of Wayne, 10 N.J. 165, 89 A.2d 693 (1952), *cert. denied,* 344 U.S. 919 (1953); Stover v. New York, 12 N.Y.2d 462, 191 N.E.2d 272, 240 N.Y.S.2d 734, *cert. denied,* 375 U.S. 42 (1963).

"family values" is permissible,[108] but zoning which *interferes* with the family in any way must be striken.

1. Interpreting *Moore*'s "Family"

Taken at face value, the Supreme Court's holding in *Moore* is very simple. Courts will not tolerate any ordinance which limits the right of a family to reside in a single-family dwelling: "[W]hen the government intrudes on choices concerning family living arrangements, this Court must examine carefully the importance of the governmental interests advanced and the extent to which they are served by the challenged regulation."[109] The Supreme Court never defined the scope of this family right, but it did rely on prior decisions in holding that the American tradition includes "uncles, aunts, cousins and especially grandparents sharing a household along with parents and children . . . ."[110]

Interpreting *Moore* in its broadest application, however, would cause several difficulties. First of all, interpreted literally, *Moore* took away the discretionary zoning power in defining the family the Court originally awarded in *Euclid.* Traditionally, the zoning power has been used to control population density and traffic and noise levels,[111] but that power was effectively curtailed by *Moore:* Families, those related by blood, marriage, or adoption, may live together no matter how many family members, how many automobiles are owned, and how much they disturb the neighborhood.[112] Related groups of eighteen or more are not inconceivable if the house can accommodate them.[113]

Second, using *Belle Terre* and *Moore,* local governments may define "family" in such a way as to legalize the social preferences of its residents. For example, a municipality may wish to develop a community without hippies, communes, or any unrelated people living together without benefit of marriage. Zoning ordinances

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[108] Village of Belle Terre v. Boraas, 416 U.S. at 9. The Belle Terre ordinance did allow two unrelated people to live together, however. Justice Douglas does not explain the correlation between "family values" and unmarried couples living together.

[109] 431 U.S. at 499.

[110] *Id.* at 504.

[111] *See generally* J. BEUSCHER, R. WRIGHT, & M. GITELMAN, CASES & MATERIALS ON LAND USE 500-29 (2d ed. 1976); Note, *The Entrenchment of the Traditional Family Structure,* 13 J. FAM. L. 901, 904 (1973-1974).

[112] Presumably, local health regulations and nuisance laws will still be available to control excesses, but the zoning tool is eliminated as to related groups.

[113] *See* note 91 *supra.*

defining "family" as only those related by blood, marriage, or adoption exclude these disfavored groups without regard to the traditional purposes of zoning, minimizing traffic and noise and protecting the environment for children.[114] In effect, zoning becomes an instrument for social control, even though it was never intended to be a means of excluding undesirables.[115]

Until the intended scope of *Moore* is clarified by the Supreme Court, local authorities will have to continue their attempts to regulate single-family districts by formulating various alternatives to the restrictive scheme struck down in *Moore*.

2. Supreme Court Oversight: The Power to Regulate People

Proper drafting of zoning ordinances requires the enacting muncipality to carefully formulate its objectives. If a city's sole object is preservation of the traditional family, those related by blood, marriage, or adoption, *Belle Terre* and *Moore* give planners the requisite judicial guidelines: A zoning ordinance may be drafted in furtherance of "family needs" and "family values,"[116] but "family" must include all blood relatives rather than the so-called nuclear family.[117]

If, however, municipalities wish to achieve other, more traditional zoning objectives, such as prevention of overcrowding and traffic congestion[118] or preservation of neighborhood character and property values,[119] restrictive definitions of "family" do little or nothing to further these aims.[120] On the contrary, such regula-

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[114] *Euclid*, 272 U.S. 365, 394 (1926).

[115] Note, *No Dogs, Cats or Voluntary Families Allowed*, 24 DEPAUL L. REV. 784, 795 (1975); Note, *An Extension of the State's Police Power: The Protection of Family Values Through Zoning Legislation*, 21 LOY. L. REV. 243, 247 (1975); Comment, 50 WASH. L. REV. 421, 435 (1975).

[116] Village of Belle Terre v. Boraas, 416 U.S. at 9.

[117] Moore v. City of East Cleveland, 431 U.S. at 504-06.

[118] *See* text accompanying note 35 *supra*.

[119] See Timberlake v. Kenkel, 369 F. Supp. 456, 458 (E.D. Wis. 1974).

[120] The Court in *Moore* recognized that the East Cleveland definition did little to further its supposed aims:

> For example, the ordinance permits any family consisting only of a husband, wife, and unmarried children to live together, even if the family contains a half-dozen licensed drivers, each with his or her own car. At the same time it forbids an adult brother and sister to share a household, even if both faithfully use public transportation.

431 U.S. at 500. Three years earlier, Justice Marshall made a similar point about the marginal utility of Belle Terre's ordinance. *See* text accompanying note 89 *supra*.

tions serve no purpose except to interfere with a property owner's "right to use her own property as she sees fit."[121]

The basic failing of both East Cleveland and Belle Terre is that in drafting their respective ordinances, they attempted to determine *who* might use their single-family dwellings. Rather, the two cities should have looked to see if restrictive definitions of "family" bore any relation to reduction of overcrowding or preservation of property values.[122] Quite simply, these ends cannot be achieved by prohibiting a grandmother from living with her grandchild[123] or prohibiting more than two unrelated people from living together.[124] By focusing on who might occupy a single residence, the two municipalities lost sight of zoning's proper function, regulating the use of land for residential dwellings. A brief overview of zoning development demonstrates how this failing came about.

Zoning began very simply. *Euclid*[125] held that a local government had the power to classify the use of land into three categories, residential, commercial, and industrial. Each of the three classifications was broken down further as zoning became more complex. Residential zones were subclassified into single-family and multi-family uses, but the city's power to regulate was still limited: It could regulate how a landowner used his property in relation to his neighbors, but it could not regulate the identity of those who used the property. When local governments began to define "family," however, the Euclidean emphasis on land *use* was subtly but definitely overthrown. *Belle Terre* represents more than Supreme Court ratification of the local power to set single-family zones; it represents judicial approval of the local power to regulate the identity of those who use the land.

Moore is the first and to date the only limitation on that power. But, far more significantly, *Moore* is a second lost opportunity to recognize and possibly reverse the changeover from land-use to "people-use." Until the Supreme Court recognizes the possible implications of the state's regulating the internal compo-

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[121] Moore v. City of East Cleveland, 431 U.S. at 513 (Stevens, J., concurring).

[122] Village of Euclid v. Ambler Realty Co., 272 U.S. 365 (1926), first enunciated a rational relationship test in zoning. *Id.* at 395.

[123] Moore v. City of East Cleveland, 431 U.S. at 499.

[124] Village of Belle Terre v. Boraas, 416 U.S. at 16 (Marshall, J., dissenting).

[125] 272 U.S. 365 (1926).

sition of households, local authorities can presumably exclude "undesirables"[126] from their neighborhoods and justify the exclusion under *Belle Terre* and *Moore*. As Justice Marshall concluded three years ago:

> Zoning officials properly concern themselves with uses of the land—with, for example, the number and kind of dwellings to be constructed in a certain neighborhood or the number of persons who can reside in those dwellings. But zoning authorities cannot validly consider who those persons are, what they believe, or how they choose to live, whether they are Negro or white, Catholic or Jew, Republican or Democrat, married or unmarried.[127]

The *Euclid* power to govern land use was never intended to validate the regulation of individual lifestyle choices.[128] The courts and municipalities must recognize the growth of and the need for limits on the power to regulate people.

CONCLUSION

The development of zoning law from *Euclid* and *Nectow* to *Belle Terre* and *Moore* has brought with it a subtle but important new zoning power. Not only do localities have the power to regulate uses on the land; they have also acquired the power to regulate the people who use the land. Unfortunately, the Supreme Court has failed to address the evolution of this new power, attempting to evaluate the scope of that power with respect to traditional objectives the old power was supposed to achieve. The result of this failure is that the Court has upheld zoning ordinances which determine the internal composition of households without ever questioning the purpose of such regulation.

Recognition that there must be limitations on the power to govern the composition of households is the first step toward reversing the trend. Local governments must have the power to control use of the land, but that power should not be expansively construed to allow control of who uses the land or in what manner.

Belle Terre and *Moore* must be reanalyzed. The power to decide whether a piece of property may be used for residential,

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[126] *See* text accompanying note 115 *supra*.

[127] Village of Belle Terre v. Boraas, 416 U.S. at 14-15 (Marshall, J., dissenting).

[128] Note, *An Extension of the State's Police Power: The Protection of Family Values Through Zoning Legislation*, 21 LOY. L. REV. 243, 247 (1975).

commercial, or industrial purposes belongs to the state. The power to decide who resides on a piece of residential property properly belongs—and must be returned—to the property owner.

David W. Miller

Singleton v. Wulff: Extension of the Right of Privacy Through Standing

Introduction

Missouri participates in the Medicaid program, under which the Federal government partially underwrites qualifying state plans for medical assistance to the needy.[1] Missouri's plan[2] includes a list of twelve categories of medical services that are eligible for Medicaid funding. The last category provides medical assistance payments for pregnancies carried to term or for therapeutic abortions, but denies such payments for nontherapeutic abortions.[3]

In 1974 two Missouri-licensed doctors brought suit challenging the constitutionality of the state Medicaid Statute.[4] The district court dismissed for lack of standing to bring the action. On appeal, the Eighth Circuit Court of Appeals, in *Wulff v. Singleton*,[5] held that the physicians did have standing to bring the action. In reaching a similar decision on the subsequent appeal to the Supreme Court, Mr. Justice Blackmun held that the plaintiffs-physicians had standing to assert their own rights since they suffered concrete injury of an economic and professional nature from the operation of the challenged statute.[7] The Court also held[8] that physicians should be allowed to assert the rights of their women patients to be free of the unconstitutional governmental interference with the decision to terminate pregnancy.[9] This comment will examine the Court's rationale for granting the physicians standing on each basis.

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[1] 42 U.S.C. §§ 1396(a)-1396(g) (1970 & Supp. IV 1974).

[2] Mo. Rev. Stat. §§ 208.151-208.158 (Supp. 1975).

[3] Mo. Rev. Stat. § 208.151(12) (Supp. 1975) ("Family planning services as defined by federal rules and regulations; provided, however, that such family planning services shall not include abortion unless such abortions are medically indicated." *Id.*).

[4] Wulff v. State Bd. of Registration for Healing Arts, 380 F. Supp. 1137 (E.D. Mo. 1974).

[5] 508 F.2d 1211 (8th Cir.), *cert. granted*, 420 U.S. 1041 (1975).

[6] 428 U.S. 106 (1976).

[7] *Id.* at 112-13.

[8] *Id.* at 118.

[9] Justice Stevens, concurring, agreed with the Court's conclusion but, since he was not sure that the plurality's analysis would sustain the physicians' standing to represent their patients, he did not join in that part of the opinion. *Id.* at 121-22. Justice Powell, joined by the Chief Justice, Justice Rehnquist, and Justice Stewart, dissented as to the issue of representation. *Id.* at 122.

I. STANDING OF PHYSICIANS TO ASSERT THEIR OWN RIGHTS

A. *Analysis of* Wulff

The concept that a physician must show direct personal injury to be granted standing was first considered in the context of abortion cases in *Roe v. Wade*[10] and *Doe v. Bolton.*[11] The principal question in these cases was whether a state could constitutionally prohibit an abortion except when it was necessary to protect the life of the mother.[12] In each case, the Court granted the physician standing to challenge a criminal abortion statute. The Court reasoned that a sufficiently direct threat of personal detriment existed because the physicians were the ones against whom such statutes were aimed.[13]

In *Griswold v. Connecticut,*[14] as in *Roe* and *Doe,* a physician, who was criminally charged as an accessory to the crime of using birth control devices and thus had a direct personal stake in the result of the litigation, had standing to challenge the statute on his own behalf.

These cases, relied upon by the Court, are best interpreted as supporting only the limited proposition that the existence of a criminal statute which directly affects the interests of a physician will suffice to grant the physicians standing to challenge that statute. *Wulff* can be distinguished from each of these cases. The Missouri Medicaid statute imposes no criminal penalties upon the physicians and in this respect does not serve to directly and adversely affect their interests. The physicians are free to perform abortions without fear of any possible prosecution.

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[10] 410 U.S. 113 (1973).

[11] 410 U.S. 179 (1973).

[12] The Court's reason for recognizing the constitutional right to have an abortion was that this decision lay within the right of privacy previously identified by the Court. *See* Doe v. Bolton, 410 U.S. 179, 209-15 (1973); Roe v. Wade, 410 U.S. 113, 152-54 (1973). The leading modern case establishing a constitutional right of privacy is Griswold v. Connecticut, 381 U.S. 479 (1965), in which the Supreme Court held invalid a state law prohibiting the use of contraceptive devices as applied to people who operated a birth control clinic. The Court rested its decision on the conclusion that a number of specific guarantees of the Bill of Rights protected "peripheral" rights or "penumbral" zones, some of which came together to form a constitutionally protected zone of privacy. The marriage relationship lay within this zone of privacy and it would be a violation of this interstitial right to permit governmental intrusion to enforce the anti-contraceptive law. *Id.* at 483-86.

[13] 410 U.S. at 124; 410 U.S. at 188.

[14] 381 U.S. 479 (1965).

Another case the Court regarded as lending support to its grant of standing to the physicians concerns a municipal hospital resolution which prohibited use of hospital facilities for nontherapeutic abortions. In *Nyberg v. City of Virginia,*[15] the District Court granted the physicians standing on two grounds: First, they have a right to practice medicine according to the highest medical standards without unreasonable restraints; second, they cannot be arbitrarily deprived of an opportunity to perform abortions which may account for a portion of their livelihood.[16]

Although, as in *Wulff,* the *Nyberg* Court found that potential economic injury was sufficient to grant standing, the physician's ability to perform abortions in *Nyberg* was severely limited due to the resolution adopted. The Medicaid statute under attack in *Wulff* neither prohibits nor limits the physicians in the performing of abortions. Therefore, *Wulff* is again distinguishable.

This analysis indicates that a grant of standing to the physicians in *Wulff* based on their own direct injury is questionable.[17] Since only the welfare recipients are directly affected under the Medicaid statute, they are the only proper parties to seek relief.

B. *Analysis of the Leading Cases*

Although the Court can be criticized for its analysis in *Wulff,* the court's inconsistency in this case brings into focus a more significant problem with the Court's general methodology. *Wulff* is an example of the Court's unwillingness to set out the various considerations that arise when plaintiffs seek standing to complain of injuries caused by remote governmental action. The Court tends to focus its decision around a narrow range of factors that are more easily susceptible to classification and rulemaking than are the policy concerns and values implicit in standing decisions. An attempt is made to root out the actual considerations of the Court in the recent cases utilized by the *Wulff* Court. *Wulff* is compared with these leading cases and reappraised in terms of the factors the Court weighed in reaching its determination to grant standing. This analysis will provide a reasonable basis for predicting future standing cases.

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[15] 495 F.2d 1342 (8th Cir.), *cert. denied,* 419 U.S. 891 (1974).

[16] *Id.* at 1344.

[17] *See* Note, *Denial of Equal Protection to Patient as also Constituting Denial of Equal Protection to Physician,* 7 U. Tol. L. Rev. 213 (1975).

In *Linda R.S. v. Richard D.*,[18] an unwed mother sought to enjoin the discriminatory application of a Texas criminal child support statute to parents of legitimate children only, claiming that the district attorney unconstitutionally discriminated against her illegitimate children by refusing to prosecute their father for failure to provide child support.[19] The Court determined that it was speculative whether the injury would be remedied even if the relief was granted because the only result of success on the merits would be to send the father to jail.[20]

Mr. Justice White criticized the majority's reasoning, arguing that criminal sanctions are useful in coercing fathers to meet their support obligations.[21] What is important to notice is that the dissent's position, though resulting in an opposite conclusion from the majority, is just as valid. Presumably, other factors persuaded the Court to deny standing.

The controlling reason for denying standing was implied when the Court pointed out that a person lacks standing to contest the policies of the prosecuting authority when that person is neither prosecuted nor threatened with prosecution.[22] The underlying policy decision is that an interested and indirectly injured party should not be permitted to interfere in prosecutorial decisions. By explicitly basing its decision to refuse standing on the plaintiff's actual prospects for relief, the Court needlessly introduced a new concept into the law of standing.[23]

In *United States v. SCRAP*,[24] five law students challenged a ruling of the Interstate Commerce Commission (ICC) which allowed a surcharge on railroad rates, pending the adoption of rate increases, until an environmental impact study was made under the National Environmental Policy Act (NEPA).[25] Plaintiffs

[18] 410 U.S. 614 (1973).

[19] *Id.* at 614-15.

[20] *Id.*

[21] *Id.* at 621.

[22] *Id.* at 619.

[23] The Court, in Warth v. Seldin, 422 U.S. 490 (1975), cited Linda R.S. v. Richard D., 410 U.S. 614 (1973), as support for its new causation test. The ultimate question in *Warth* was not whether the defendant harmed plaintiffs in a specific way, but whether the Court felt that it should provide effective relief. 422 U.S. at 504. The Court's reliance on *Linda R.S.* illustrated this concern.

[24] 412 U.S. 669 (1973).

[25] National Environmental Policy Act, 42 U.S.C. § 4342(2)(c) (1970).

sought standing under section 10 of the Administrative Procedure Act[26] claiming that the surcharge would result in discrimination against the hauling of recyclable goods and thereby damage the environment.[27] The Court granted standing by applying the liberal test that a complaint should be considered unless it appears beyond a doubt that the plaintiff could prove no set of facts in support of his claim which would entitle him to relief. The result in *SCRAP* seems sensible only because the speculative injury was of the type contemplated by the statute alleged to be violated. NEPA required an environmental impact statement thereby indicating that the purpose of the legislation was to protect against possible harm to the environment. Therefore, if the Court had denied standing on the grounds that the plaintiffs' only harm was concern over the possible detrimental environmental effects, it necessarily would have defeated the purpose of NEPA. A further policy behind the Court's refusal to dismiss the claim is the Court's evident willingness to give environmental litigants the opportunity to more easily and securely raise environmental claims.[28]

The Court, however, chose not to base its holding on the specific concerns of the case and instead, the case was made to turn on a procedural point. The Court stated that although plaintiffs might have been required to make a stronger showing of causality on a motion for summary judgment, they should not be forced to show more on a motion to dismiss.[29] This holding represents a failure of the Court to take responsibility for articulating the significant environmental considerations which undoubtedly led the Court to search for some procedure safeguard on which to ostensibly base their decision.[30]

[26] Administrative Procedure Act, § 10, 5 U.S.C. § 720 (1970), which provides: "A person suffering legal wrong because of agency action, or adversely affected or aggrieved by agency action within the meaning of a relevant statute, is entitled to judicial review thereof."

[27] Plaintiffs allege that the rate structure would selectively discourage the transportation and use of recyclable materials, consequently increase the consumption of natural resources, and thereby result in the proliferation of refuse and litter. The railroad replied that the surcharge represents a general rate increase and would not discourage the movement of scrap materials. 412 U.S. at 676.

[28] For a discussion advocating a liberal viewpoint regarding standing, see generally *The Liberalized Law of Standing*, 37 U. CHI. L. REV. 450 (1970); Tucker, *The Metamorphosis of the Standing to Sue Doctrine*, 17 N.Y.L.F. 911, 929 (1972).

[29] 412 U.S. at 689.

[30] For a discussion of relevant considerations underlying situations like *SCRAP*, see

In *Schlesinger v. Reservists Committee to Stop the War*,[31] the citizens-plaintiffs sought a declaration that members of Congress were ineligible to hold a commission in the Armed Forces Reserve because of the incompatibility clause of the Constitution.[32] The plaintiffs alleged that a violation of the incompatibility clause would deprive citizens of the faithful discharge of legislative duties by reservist members of Congress.[33] The Court would not grant standing because of the abstract and speculative nature of the allegation.[34]

The weakness of the Court's decision is that a rule requiring concrete injury is illogical and inappropriate when applied to a constitutional provision which is designed to protect against injuries that are not necessarily concrete. The incompatibility clause is aimed at eliminating the possible ill effects on the legislature and the public from conflicts of interest in Congresspersons. Thus, if the plaintiffs in *Reservists* are concerned that Congresspersons may fail to discharge their duties faithfully because of conflict of interest, then the plaintiffs are suffering the very injury the provision was designed to prevent.[35]

One explanation for the *Reservists* decision was the Court's concern for the implications of allowing citizens to involve legislators in suits grounded on abstract and speculative allegations, which if sanctioned in courts, would impair a legislator's ability to perform his duties on grounds which may amount to no more than suspicion. In addition, the embarrassment associated with

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generally Comment, *Standing to Challenge Governmental Actions Which Have an Insubstantial or Attenuated Effect on the Environment*, 1974 DUKE L.J. 491.

[31] 418 U.S. 208 (1974).

[32] "[N]o Person holding any office under the United States, shall be a Member of either House during his Continuance in Office." U.S. CONST. art. I, § 6, cl. 2.

[33] 418 U.S. at 212.

[34] *Id.* at 220.

[35] The problem of determining what injuries will be deemed concrete is particularly apparent when Schlesigner v. Reservists Comm. to Stop the War, 418 U.S. 208 (1974), is compared with United States v. SCRAP, 412 U.S. 669 (1973), where possible harm to aesthetic and environmental interests was considered a sufficient injury in fact. In Justice Marshall's dissent in *Reservists*, he expressed concern about the different results reached in these two cases, stating that it was reprehensible that the Court's priorities would allow hearing a claim involving interference with aesthetic appreciation of natural resources, but would not countenance one involving violation of a specific constitutional provision. 418 U.S. at 239-40. Implicit in this contrast is the fact that the Court recognizes a varying hierarchy of values, the more important of which will provide a controlling consideration in the decision regarding standing.

such litigation could be politically detrimental thus encouraging nuisance suits. But by not giving express weight to these policy considerations, the Court raised for subsequent courts formidable questions about the degree of concreteness needed for standing and created confusion as to the contextual appropriateness of the concrete injury test.

In *Warth v. Seldin,*[36] one group of plaintiffs consisted of low and moderate income individuals who resided outside of the town of Penfield. They claimed that Penfield's zoning ordinance had prevented persons of low and moderate income from acquiring residential property in the town.[37] In denying those plaintiffs standing, the Court enunciated a new causation test. The plaintiffs must allege facts from which it could reasonably be inferred that, absent Penfield's restrictive zoning practices, there would be a substantial probability that they would have been able to purchase or lease in Penfield.[38] The plaintiffs were denied access to federal court because they had not demonstrated that they personally would benefit in a tangible way from federal court intervention.[39] The Court, while recognizing that plaintiffs suffered a loss of housing opportunity, decided that this injury was not caused by Penfield's asserted illegal acts but rather was a consequence of the economy of the area housing market.[40]

The *Warth* Court used standing as a device to limit its policymaking role in the exclusionary zoning area rather than as a device to measure the sufficiency of plaintiffs' injuries. Although clothed as a constitutional decision that an insufficient causal relationship existed between plaintiffs' exclusion and Penfield's zoning ordinance to warrant effective relief,[41] *Warth* is based on a prudential determination to impose higher injury in fact standards where constitutional rights are being adjudicated.[42] By bas-

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[36] 422 U.S. 490 (1975).

[37] The community's land use ordinance allocated 98% of the town's vacant land to single-family dwellings. Only .3% of the land available for residential construction was zoned for multifamily dwellings. *Id.* at 495.

[38] 422 U.S. at 504.

[39] *Id.* at 503-07.

[40] *Id.* at 506.

[41] The Court's reliance on Linda R.S. v. Richard D., 410 U.S. 614 (1973), illustrated this concern. 422 U.S. at 504 & n.79.

[42] *See* C. WRIGHT, A. MILLER, & E. COOPER, FEDERAL PRACTICE AND PROCEDURE: JURISDICTION § 3531, at 18 (Supp. 1975).

ing its rationale on the issue of causality, the Court distorts the complex standing problem presented in *Warth* and sheds no light on the considerations it thought important.

C. *Conclusion*

The Court's treatment of injury in fact without any particularization in light of either the policies properly implicated or the context of the relevant precedent threatens that it will become a catchall for an unarticulated discretion on the part of the Court. Too often various considerations have been merged into one confused inquiry concerning standing. The Court, in *Wulff*, disguised its reasoning by focusing on the economic nature of the injury asserted and the professional relationship involved. By basing its decision on these aspects, the Court neglected the important difference between the precedent and *Wulff* in that the physicians alleged no direct personal injury under a criminal statute. By ignoring this disparity, the Court effectuated its policy consideration of expanding the constitutional right of privacy concerning governmental intrusions into matters relating to marriage, procreation, and family relationships by granting standing to physicians to contest statutes which prevent or severely restrict them in the performing of abortions.[43] In *Wulff*, the Court has actually sought to emphasize that decisions arising out of the physician-patient relationship are constitutionally protected under the right of privacy, but in doing so, has failed to take responsibility for articulating this as the paramount concern.

Underlying this tension is the Court's inability to fashion a general rule substantially applicable within similar contexts. It is necessary for the Court to place cases within meaningful groupings, to recognize within these groupings the considerations properly evoked in determining standing, and to articulate clearly and consistently through a more descriptive analysis the controlling factors in future cases.

II. STANDING TO ASSERT CONSTITUTIONAL JUS TERTII

The second basis upon which the Court granted standing to the physicians in *Wulff* was as representatives of their patients.

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[43] A generalized right of privacy is nowhere mentioned in the Constitution. It is entirely the creation of the judiciary. *See* discussion note 12 *supra*.

Although the Court has proclaimed a general presumption against the representative assertion of a person's right (jus tertii),[44] the Court looks primarily to two factual elements to determine whether this presumption should apply in a particular case. The first is the ability of the third party to assert his own right.[45] The second[46] is the presence of a substantial relationship between the litigant and the person whose rights he seeks to assert.[47]

Applying these principles led the Court to grant jus tertii.[48] The Court found several obstacles to the women's assertion of their own rights. They could be chilled from asserting their rights by a desire to protect the privacy of their decision. Also, the Court stressed the imminent mootness of any individual woman's claim.[49] The closeness of the relationship was satisfied by the confidential nature of the physician-patient relationship. Each of these factors is considered below.

A. *Analysis of the Leading Cases: Obstacles*

The Court reneges on its committment to the first factual element justifying an exception when, after admitting that the mentioned obstacles are surmountable through the use of a pseudonym or assembled class action,[50] the Court concludes that if the assertion of a woman's right is to be representative to that extent

[44] 428 U.S. at 114 (citing Barrows v. Jackson, 346 U.S. 249, 255 (1953)). This rule was first enunciated in Tileston v. Ullman, 318 U.S. 44 (1943), where a physician was denied standing to attack a state anti-contraceptive statute in a declaratory judgment action on the grounds that it endangered the lives of three of his patients and consequently constituted a deprivation of life without due process of law. The Court held that his patients were not parties to the proceeding and that there was no basis on which to secure an adjudication of his patients' constitutional rights. *Id.* at 46. The primary consideration was the fact that there was no bar to the patients asserting their own rights on their own behalf.

[45] 428 U.S. at 116.

[46] *Id.* at 115.

[47] *Id.* (citing Doe v. Bolton, 410 U.S. 179, 188-89 (1973); Roe v. Wade, 410 U.S. 113, 116 (1973); Eisenstadt v. Baird, 405 U.S. 438, 445-46 (1972); Griswold v. Connecticut, 381 U.S. 479, 481 (1965); Barrows v. Jackson, 346 U.S. 249, 259 (1953)).

[48] 428 U.S. at 118.

[49] *Id.* at 117.

[50] Suit may be brought under a pseudonym. Furthermore, the case should not be treated as moot since the question is likely to recur and a holding of mootness would make it difficult or impossible for an important constitutional question to ever be presented for decision by the Court. *See* Roe v. Wade, 410 U.S. 113, 124-25 (1973). The Court, in Singleton v. Wulff, 428 U.S. 106 (1976), suggests that a class could be assembled, whose fluid membership always included some women with live claims. *Id.* at 117.

anyway, then there seems little loss in terms of effective advocacy from allowing its assertion by a physician.[51] This argument indicates that the Court is willing to allow jus tertii whenever personal litigation becomes practicably impossible.[52]

An analysis of the precedent relied upon by the plurality confirms the necessity of practicable impossibility. *Wulff* can be distinguished from these cases because the factor of impossibility is not present so as to justify the Court in granting an exception.

In *Barrows v. Jackson,*[53] a covenantor who sold land to a black purchaser in violation of a racially restrictive covenant was granted jus tertii, when he was sued for damages by another party to the covenant, to assert that enforcement of the convenant by an award of damages would violate the equal protection rights of prospective black purchasers of similarly restricted property. The Court argued that it would be "difficult if not impossible" for the prospective vendees to assert their grievance before any court.[54]

Other factors confirm the virtual impossibility of prospective black vendees asserting their own constitutional rights. First, the victim of the possible discrimination would not be known.[55] Second, it is difficult to see how, in the absence of a contract to sell, a black purchaser could have an actionable interest. And finally, there would be no chance, even under broad intervention rules, that a black would become a party to any proceeding to protest that the awarding of damages to a covenantor would impair his right to purchase property in the future.[56]

In *NAACP v. Alabama,*[57] the NAACP, in resisting efforts to enjoin it from doing business in the State of Alabama, had standing to assert that compulsory production of membership

[51] 428 U.S. at 117-18.

[52] *Id.* at 126.

[53] 346 U.S. 249 (1953).

[54] *Id.* at 257.

[55] The Court refers to them as "unidentified but identifiable," meaning persons who might want to purchase a house but could not do so because of the racially restrictive covenant. *Id.* at 254.

[56] The federal courts recognize two types of intervention: 1) Intervention by right where conferred by federal statute and 2) intervention discretionary with the court where the intervenor's claim or defense involves a question of law or fact common to the action. FED. R. CIV. P. 24.

[57] 357 U.S. 449 (1958).

lists violated the constitutional rights of its members to freedom of association.[58] The action of the state was claimed unconstitutional because it would have deprived the members of their right to remain anonymous and to keep their membership in the organization secret. The members would have had to forgo those rights in order to assert them. The only possible way that their rights could have been effectively protected was to permit the association to assert them.[59]

In *Eisenstadt v. Baird,*[60] an advocate of birth control who was prosecuted for violating a statute forbidding the distribution of contraceptives to unmarried persons had standing to assert the constitutional claims of persons to whom he had distributed contraceptives.[61] The Court reasoned that since the statute prohibits, not use, but distribution, persons denied access to contraceptives are not themselves subject to prosecution and, to that extent, are denied a forum in which to assert their own rights.[62]

Singleton v. Wulff[63] can be distinguished from the *Barrows* line of cases on the issue of jus tertii in that the third party patients can easily seek relief on their own behalf.[64] The Missouri

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[58] *Id.* at 466.

[59] An effective way of counteracting pressures designed to nullify the constitutional rights of others may be to permit a third person who is not subject to the same pressures to assert them jus tertii.

[60] 405 U.S. 438 (1972).

[61] MASS. GEN. LAWS. ANN. Ch. 272, §§ 21, 21A (West 1970).

Section 21 provides in part: "Except as provided in section twenty-one A, whoever . . . gives away . . . any drug, medicine, instrument or article whatsoever for the prevention of conception . . . shall be punished by imprisonment . . . or by a fine . . . ."

Section 21A provides in part: "A registered physician may administer to and prescribe for any married person drugs or articles intended for the prevention of pregnancy or conception. A registered pharmacist . . . may furnish such drugs or articles to any married person presenting a prescription from a registered physician."

[62] The Court found a comparatively stronger basis for granting jus tertii than in Griswold v. Connecticut, 381 U.S. 479 (1965), where a physician who was criminally charged as accessory to the crime of using birth control devices had standing to assert that the Connecticut anti-birth control measure violated the constitutional rights of his patients to privacy in marital relations. The Court argued that unmarried persons denied access to contraceptives in Massachusetts, unlike the users of contraceptives in Connecticut, are not themselves subject to prosecution and, consequently, under the statute are denied a forum in which to assert their own rights. The Massachusetts statute, unlike the Connecticut statute considered in *Griswold*, prohibits the distribution, not the use, of contraceptives. 405 U.S. at 446.

[63] 428 U.S. 106 (1976).

[64] *See* Note, *Denial of Equal Protection to Patients as also Constituting Denial of Equal Protection to Physicians,* 7 U. TOL. L. REV. 213, 221-22 (1975).

Medicaid statute expressly provides the welfare recipients with a statutory right to an administrative hearing if their claims for medical assistance are denied.[65] Furthermore, the welfare recipients are afforded the right to appeal decisions regarding requests for medical assistance payments through the administrative process as required by federal legislation and established under the Missouri Revised Code.[66] By this direct statutory endowment, absent in *Barrows, NAACP,* and *Eisenstadt,* the patients in *Wulff* are granted the means to assert their rights on their own behalf.

One of the difficulties in applying the obstacle test is a lack of Court guidance in determining what relative degree of impracticability is conclusive to warrant the assertion of a third party's rights. As it stands, the test does not serve its intended purpose of providing a reasonably useful criterion for factually determining standing, but rather lends itself to whatever measure of adaptation serves the Court's discretion in granting or in refusing jus tertii on prudential grounds. This test, like the causation test, is another example of how the Court obscures what is at issue in a given case by creating an analytic device that can be stretched to accommodate the unarticulated discretion of the Court. The Court can fashion this test, as it did in *Wulff,* to grant or to refuse standing without either an enunciation of the policies properly implicated or a close regard for the context of relevant precedent.

B. *Analysis of the Leading Cases: Physician - Patient Relationship*

Focusing on the professional relationships in *Barrows, Griswold, Eisenstadt,* and *Doe,* the Court indicated that allowing physicians in *Wulff* standing to assert their patients' rights flows naturally from these decisions.[67] To the extent that there is a preexisting and substantial relationship[68] rather than a fortuitous

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[65] MO. REV. STAT. § 208.156 (Supp. 1975) ("The department of public health and welfare shall provide for granting an opportunity for a fair hearing to any applicant or recipient whose claim for medical assistance is denied or is not acted upon with reasonable promptness." *Id.*).

[66] 38 Fed. Reg. 22007, § 205.10(a)(5) (1973) ("An opportunity for a hearing shall be granted to any applicant who requests a hearing because his claim for financial or medical assistance is denied . . . and to any recipient who is aggrieved by any agency action resulting in suspension, reduction, discontinuance, or termination of assistance." *Id.*).

[67] 428 U.S. at 115.

[68] *Id.* at 117.

one, the Court seems willing to grant jus tertii.[69] An analysis of these cases demonstrates that the *Wulff* Court has not clearly recognized that a relationship has no abstract importance but rather assumes significance by establishing a link between the claimant's injury and the constitutional right of the third party.

In *Barrows v. Jackson,*[70] the issue was whether the right of prospective black purchasers of real estate to be free from racial covenants implied or necessitated derivative protection for white sellers to be free from damages for breach of the covenant by selling to blacks. The vendor-vendee relationship was protected because the policy against discrimination implied collateral protection for white sellers.[71]

In the birth control controversies of *Griswold v. Connecticut*[72] and *Eisenstadt v. Baird,*[73] suppliers of contraceptive materials

[69] We should expect that the Court's sensitivity to the importance of a particular kind of relationship would vary from time to time as a general reflection of the existing social values. Today, for example, the Court is more apt to recognize the significance of a professional or fiduciary relationship as opposed to a commercial relationship and find that for certain social policy reasons one is more deserving of the Court's protection than the other. This change in emphasis illustrates how judicial doctrine develops in response to the particular problems and attitudes of a given social period and confirms the Court's social function as an arbiter and maker of policy. This course of development is both reasonable and desirable when you consider that the security of commercial transactions is embodied in established contract law doctrine while various protections of personal liberties have only recently come to be explained as resting on a constitutional right of privacy. It is not surprising, then, that the Court has taken a more active role to safeguard matters relating to marriage, procreation, and family relationships since the protection of these recently conceived liberties is not yet embodied in any established legal doctrine. *See also* discussion in note 82 *infra.*

As one example of increased judicial sensitivity, notice that the effect of holding a statute to be overbroad is to relax the usual standing rule that a litigant challenging a statute must show that his or her own conduct was constitutionally protected. In the preferred first amendment area, a litigant may attack a statute's constitutionality on overbreadth grounds even though the litigant may have engaged in conduct that the state could constitutionally have regulated by a statute that was more narrowly drawn. The primary reason for this extended base of standing is that the Court has been concerned about potential self-censorship by other persons who might be afraid to engage in protected speech because of the statute's broad coverage. If such persons did not speak, then the statute would have an inhibiting effect on constitutionally protected speech. *See e.g.,* Gooding v. Wilson, 405 U.S. 518, 521-22 (1972).

[70] 346 U.S. 249 (1953).

[71] The Court implicitly recognized this reasoning when it granted the vendor jus tertii to challenge restrictive covenants because the owner "is the one in whose charge and keeping reposed the power to continue to use the property to discriminate or to discontinue such use." *Id.* at 259.

[72] 381 U.S. 479 (1965).

[73] 405 U.S. 438 (1972).

were prosecuted under statutes forbidding use in Connecticut and distribution in Massachusetts, respectively. By granting jus tertii to the physicians in each case, the Court implicitly recognized the dependent nature of the relationship between enjoyment of a constitutional protection and the guarantee of access. The Court reasoned that the rights of recipients were likely to be diluted or adversely affected if they could not be asserted by the physicians.[74]

In *Roe v. Wade*[75] and *Doe v. Bolton*,[76] a patient's right to privacy was held to confer upon her physician a resultant right to perform abortions during her protected period. Physicians have a protected interest in performing abortions by virtue of the policy toward women. The Court argued in *Roe*[77] that a woman's exercise of her right to an abortion is necessarily at stake since she cannot safely secure an abortion without the aid of a physician.

In *Singleton v. Wulff*,[78] the Court emphasized that the presence of the confidential physician-patient relationship merged the physician and his patient for constitutional standing purposes.[79] By stressing the importance of a particular type of relationship that would justify an exception to the general rule, the Court offered a principle which is subordinate in importance to the nature of the governmental impact upon that relationship.[80] This analysis indicates that what is important is not whether a parciular category of relationship exists but rather whether the Missouri statute substantially impairs the expectancies or characteristics naturally arising out of the physician-patient relationship.

By placing primary emphasis on the nature of the relationship, the plurality seems to be generating a category of relationships, anyone of which, in itself, would justify a grant of jus tertii. The problem with this reasoning is that it promises to provide a

[74] 381 U.S. at 481; 405 U.S. at 445-46.

[75] 410 U.S. 113 (1973).

[76] 410 U.S. 179 (1973).

[77] Roe v. Wade, 410 U.S. 113, 153-56 (1973).

[78] 428 U.S. 106 (1976).

[79] *Id.* at 117.

[80] The dissent would keep the emphasis on the impact of the litigation on the third party interests and treat the closeness of any relationship as only one factor in determining whether the third party interests will be represented adequately. *Id.* at 128 n.5.

reasonably useful criterion for factually determining jus tertii, but in actuality only surfaces one factor that a court should consider in deciding standing. Besides the presence of a substantial relationship, equally important factors are the nature of the governmental impact upon that relationship and the degree to which the third party is dependent on the claimant for the protection of his right. Although the Court recognized these contextual factors,[81] by analyzing *Wulff* in terms of a general rule with principled exceptions, the Court obscured the importance of these factors and failed to articulate the rationale behind the significance given to a professional relationship.

C. *Conclusion*

Although the Court has exercised its discretion to proclaim a general presumption against standing to assert the constitutional claims of third parties, the Court has recognized many departures from this rule. The frequency with which the Court has allowed exceptions suggests the lack of any coherent justification for the Court's general rule. This uncertainty can be attributed to the Court's failure to articulate the policy considerations properly implicated by its decisions and to recognize that these concerns cannot be itemized according to any principled criteria but rather are more accurately based on a variety of factors implicit in the various contexts in which jus tertii arises. By attempting to structure its reasoning with reference to two conclusive factors, the Court obscures the process by which the scope of jus tertii is determined.

Although it is generally wise to limit the assertion of jus tertii, there are instances where, in order to perpetuate other significant values, there must be a relaxation of the standing requirement. In such instances, it is imperative that the Court develop and apply well defined considerations so that neither set of values is diminished.[82] At the present time, the Court is more

[81] The Court reasons that the woman's exercise of her right to an abortion is necessarily at stake in Singleton v. Wulff, 410 U.S. 106 (1976), because "an impecunious woman cannot easily secure an abortion without the physician's being paid by the State." *Id.* at 117. In addition, "[T]he constitutionally protected abortion decision is one in which the physician is intimately involved." *Id.*

[82] For example, to the extent that the Court is willing to give special protection to a particular right or value, it may be willing to take a broadened view of standing when that right is asserted, although it is the right of one other than the claimant. The Court may

concerned with advancing and protecting personal liberties such as freedom from racial discrimination,[83] freedom of association,[84] and the right of privacy with respect to governmental intrusions into matters relating to marriage, procreation, contraception, and abortion.[85] This emphasis results because certain constitutional guarantees, within a given social period, inspire a greater sensitivity on the part of the Court than do others.[86] *Wulff* is an example of the Court's grappling with the task of clarifying and defining recently conceived personal liberties in matters of privacy through a broadened bases of standing to assert jus tertii.

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be eager to clarify the law in a particular area in order to prevent the inibition of the values embodied in that right because of the uncertainties as to its exact scope. Singleton v. Wulff, 428 U.S. 106 (1976) is one example of this broadened base of standing being extended to a litigant in order to insure the protection of a third party's interest, which is implicated by their relationship.

[83] *See, e.g.*, Barrows v. Jackson, 346 U.S. 249 (1953).

[84] *See, e.g.*, NAACP v. Alabama, 357 U.S. 449 (1958).

[85] *See, e.g.*, Singleton v. Wulff, 428 U.S. 106 (1976); Nyberg v. City of Va., 495 F.2d 1342 (8th Cir.), *cert. denied*, 419 U.S. 891 (1974); Doe v. Bolton, 410 U.S. 179 (1973); Roe v. Wade, 410 U.S. 113 (1973); Eisenstadt v. Baird, 405 U.S. 438 (1972); Griswold v. Connecticut, 381 U.S. 479 (1965).

[86] *See* discussion in note 69 *supra*.

Estate Planning for Farmers and Ranchers Under Section 2032A

Introduction

The Estate and Gift Tax Reform Act of 1976 added to the Internal Revenue Code the most significant estate tax legislation ever enacted for the farmer or rancher—section 2032A.[1] The congressional intent underlying section 2032A was simple: minimize inflated valuation of farmland when determining the farmer's gross estate.[2] Consequently, this new law was designed to reduce a farmer's estate tax liability if certain requirements are satisified.[3] This reduction in estate tax is accomplished by an alternative method of valuing the farmer's real estate—valuation of farmland at its current use as a farm rather than at its "highest and best use." Proper implementation of section 2032A should result in the transmission of the small family farm between generations without creating burdensome estate taxes.[4] Thus, farm families are not forced to liquidate the farm assets to cover the estate tax liability.

This paper has two principal sections. The first discusses requirements, definitions, valuation methods, and recapture of

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[1] I.R.C. § 2032A. This section was enacted into law by section 2003 of the Estate and Gift Tax Reform Act of 1976. Only estates of decedents dying after December 31, 1976 can elect section 2032A. This section applies also to realty in a closely held corporation but this paper limits its discussion to farm realty. All "sections" referenced in this paper are from the Internal Revenue Code of 1954.

[2] H.R. Rep. No. 1380, 94th Cong., 2d Sess. 21 (1976), at 22. This intent was stated in the report as follows:

> [W]here the valuation of land reflects speculation to such a degree that the price of the land does not bear a reasonable relationship to its earning capacity, your committee believes it unreasonable to require that this "speculative value" be included in an estate with respect to land devoted to farming. . . .

[3] Keydel, *Explaining the Tax Reform Act of 1976 to Clients*, Prac. Law., Mar. 1, 1977 at 11. In actual tax dollars the estate tax will be lowered by $90,000 to $350,000 depending on the tax bracket involved. *Id.* This range of tax savings is derived from the product of the lowest and highest estate tax rates under section 2001(c) and the maximum reduction in the gross estate allowed under section 2032A. The calculations are as follows:

Tax Rate		Maximum Reduction Allowed		Decrease in Tax
18%	of	$500,000	=	$ 90,000
70%	of	$500,000	=	$350,000

The maximum reduction rule is discussed in text accompanying note 32 *infra*.

[4] *Id.*

tax saved by electing the special valuation under section 2032A. The second analyzes the considerations involved to elect section 2032A, the pre-mortem planning necessary to comply with the section, and the post-mortem planning required to avoid forfeiting the benefits of the section.

I. An Inequity of the Estate Tax Laws

Under the current law, the property included in a decedent's gross estate is to be reported at its "value."[5] Treasury regulation 20.2032-2(b) defines "value" as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts."[6] Farm real estate, therefore, has been valued at the "highest and best use" of the property.[7] Consequently, because the farm property's industrial or developmental value was higher than its agricultural value, the farm either had to be sold to pay the high estate tax or converted to a nonagricultural use to increase its income and justify its retention.[8]

Reacting to this inequity, Congress enacted section 2032A to eliminate the "highest and best use" valuation and to introduce "special use" valuation.[9] In enacting the law, Congress evidently felt that a policy of encouraging retention of the "family farm" in the United States outweighed the policy of encouraging industrial development of the land.[10]

II. General Provisions of Section 2032A

A. *Requirements*

In order to qualify for its benefits, section 2032A prescribes

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[5] I.R.C. § 2031(a).

[6] (1965).

[7] H.R. Rep. No. 1380, *supra* note 2, at 21.

[8] *Id.* at 22. *See also*, Kelley, *Estate Tax Reform and Agriculture*, 7 U. Tol. L. Rev. 897 (1976); Smith & Scrow, *The Estate and Gift Reform Act of 1976: A Look at Two of the Major Provisions*, Utah B.J., Winter, 1976, at 42. The former article provides an excellent discussion of the methods of valuation before enactment of section 2032A and of the resulting hardship for the heirs of the farmer's estate. It cites one study which noted that more than 60% of all farm estates in Iowa became legally or economically fragmented following the death of the owner.

[9] H.R. Rep. No. 1380, *supra* note 2, at 22.

[10] *Cf.* Taylor, *Public Policy and the Shaping of Rural Society*, 20 S.D.L.R. 475 (1975) (for the opinion that family operated farms are the most efficient and socially desirable method of farming).

a number of specific criteria. The section applies only if the decedent was a citizen or resident of the United States and if the property is "qualified real property."[11] To be "qualified real property" an eight-point test must be met:

1. The property must be real property located within the United States;[12]
2. the property must be used at the time of the decedent's death in a "qualified use;"[13]
3. the property, along with the personal property used with such real property, must pass from the decedent to a "qualified heir;"[14]
4. the property, along with personal property used with it, must comprise at least 50 percent of the adjusted gross estate;[15]
5. the property, valued by itself at its "highest and best" use, must comprise at least 25 percent of the adjusted gross estate;[16]
6. the property must have been owned by the decedent or a "member of his family" during five of the eight years immediately preceding the decedent's death;[17]
7. there must have been "material participation" by the decedent or a "member of his family" in the operation of the property in its "qualified use" during five of the eight years immediately preceding the decedent's death;[18] and
8. the executor or other estate representative must file an election with the estate tax return which designates the realty and agrees that the recapture rules of the section will apply with respect to that property.[19]

B. *Definitions*

To understand the stated requirements of section 2032A, certain phrases defined by that section must be examined.

"Qualified real property" qualifying for "special use" valuation includes the farmhouse, or other residential buildings, and related improvements located on the farm.[20] However, such build-

[11] I.R.C. §§ 2032A(a), (b)(1).
[12] *Id.* § 2032A(b)(1).
[13] *Id.* § 2032A(b)(1)(A)(i).
[14] *Id.* § 2032A(b)(1)(A)(ii).
[15] *Id.* § 2032A(b)(1)(A). For the purposes of this test, the value of the property, real and personal, and the adjusted gross estate are determined without regard to section 2023A and are reduced by any mortgages or indebtedness on the property. *Id.* § 2032A(b)(3). *See also* section 2053(a)(4).
[16] *Id.* § 2032A(b)(1)(B).
[17] *Id.* § 2032A(b)(1)(C)(i).
[18] *Id.* § 2032A(b)(1)(C)(ii).
[19] *Id.* §§ 2032A(b)(1)(D), (d).
[20] H.R. REP. No. 1380, *supra* note 2, at 23.

ings must be occupied on a regular basis by the owner or lessee of the real property for the purpose of operating the farm.[21] "Qualified real property" also includes roads, buildings, and other structures and improvements functionally related to the "qualified use."[22] To the contrary, elements of value which are not related to the farm use, e.g., mineral rights in the form of a coal or natural gas lease, are not eligible for "special use" valuation.[23]

A "qualified use" is use as a "farm" for "farming purposes."[24] The definition of a farm is quite broad: it includes dairy, poultry, and truck farms, plantations, ranches, nurseries, ranges, greenhouses, orchards and woodlands.[25]

A "qualified heir" is defined as any member of the decedent's family to whom the real property passes.[26] "Member of the family" is defined as the decedent's spouse, ancestor, lineal descendant, or a lineal descendant of the decedent's grandparent, or the spouse of any such descendant.[27] Therefore, along with his brother and sister, the decedent's aunts, uncles, nephews, great nephews, great nieces, and cousins and their spouses, would be included as "members of the family."[28] Adopted children, also, are included as members of the decedent's family.[29]

"Material participation" is determined in a manner similar to that used for purposes of computing net earnings from self-employment under section 1402(a).[30] Although the party carrying

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[21] *Id.* at 24.

[22] *Id.*

[23] *Id. See also* Kirby, *How to Plan for New Special Rules of Valuing Farm and Close Corporation Real Estate,* EST. PLAN. Jan., 1977, at 95.

[24] I.R.C. § 2032A(b)(2)(A). See section 2032A(e)(5) for a definition of farming purposes.

[25] *Id.* § 2032A(e)(4).

[26] *Id.* § 2032A(e)(1).

[27] *Id.* § 2032A(e)(2).

[28] Case & Phillips, *Death and Taxes—The 1976 Estate and Gift Tax Changes,* 1976 ARIZ. ST. L. J. 321, 361. Under the Uniform Probate Code, which has been adopted in Colorado, every class of heir to which property could pass by intestate succession would meet the definition of a "member of the family" under section 2032A(e)(2). *Id.; See also* COLO. REV. STAT. § 15-11-103. Remarkably, section 2032A(e)(2) deviates from the Uniform Probate Code by allowing the spouses of "qualified heirs" to be members of the decedent's family.

[29] I.R.C. § 2032A(e)(2); *Cf.* COLO. REV. STAT. § 15-11-109(a) (1973) which states that for intestacy purposes an adopted person is the child of the adopting parent.

[30] I.R.C. § 2032A(e)(6). Section 1402(a) reads as follows: "The term 'net earnings from self-employment' means the gross income derived by an individual from any trade or

on the business need not be the decedent or a "member of his family," the decedent or a "member of his family" must materially participate in the business.[31]

C. *Valuation Methods*

The special valuation method provided by section 2032A, if elected, can reduce the value of the "qualified real property" by a maximum of $500,000.[32] Therefore, the personal representative must value the property at both its "highest and best use" and its actual agricultural use to determine if the difference between the two values exceeds $500,000.[33]

Section 2032A provides for one primary method of valuation, the income capitalization method. It is based on a formula of cash rentals, real estate taxes, and effective interest rates.[34] Because the elements of the formula are easily determinable, the method has three advantages: 1) "it should reduce subjectivity, and therefore controversy, in farm valuation;" 2) "it should eliminate from valuation any values attributable to the potential for conversion to nonagricultural use;" and 3) it should eliminate from valuation any values attributable to speculative factors.[35] Each element of the formula requires an average based on the five most recent calendar years ending before the date of the decedent's death.[36] The "qualified real property's" value is determined by dividing the difference between the average gross cash rental for comparable land used for farming purposes (and located in the locality of such "qualified real property") and the average state and local real estate taxes for such comparable land, by the average annual effective interest rate for all new Federal Bank loans.[37]

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business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business."

[31] H.R. REP. No. 1380, *supra* note 2, at 23.

[32] I.R.C. § 2032A(a)(2).

[33] RESEARCH INSTITUTE OF AMERICA, THE RIA COMPLETE ANALYSIS OF THE '76 TAX REFORM LAW, at 35 [hereinafter cited as RESEARCH INSTITUTE].

[34] I.R.C. § 2032A(e)(7)(A).

[35] H.R. REP. No. 1380, *supra* note 2, at 24-25.

[36] I.R.C. § 2032A(e)(7)(A).

[37] *Id.* The statute does not specify whether the interest rate for all new Federal Bank loans is to be determined from a national average or regional average. The United States is divided into twelve regions and each region's interest rate presumably would reflect the interest rate the farmer would pay to obtain the loan.

D. *Recapture of the Estate Tax*

Congress feared that unless for an extended period of time after the decedent's death the "qualified real property" is retained as a farm for farming purposes, the "qualified heirs" might obtain a "windfall" by electing actual use valuation and then proceeding to sell the property at its "highest and best use."[38] Therefore, section 2032A prescribes that a *disposition of the property* or a *cessation of the qualified use of the property* within fifteen years of the decedent's death, results in a recoupment of the estate tax originally saved by election of the special valuation method.[39]

1. Disposition of the Qualified Real Property

The report of the House Ways and Means Committee describes those dispositive acts for "qualified real property" which will subject the "qualified heirs" to the recapture provision. In general, the recapture provision is applicable to "qualified real property" that is disposed of in any way to nonfamily members.[40]

Conversely, section 2032A also provides that there is no recapture if the interest in "qualified real property" is transferred, by sale or gift, to a member of the "qualified heir's family."[41] However, this member is now deemed to be the "qualified heir" with respect to such interest even though he may have paid full value for the interest.[42] Consequently, a subsequent disposition of the interest by this deemed "qualified heir" to a nonfamily member within the fifteen year period, will trigger recapture of the estate tax from which the original "qualified heir" already had benefitted and, in addition, will impose liability for the recaptured amount on the deemed "qualified heir."

2. Cessation of Qualified Use

Cessation of qualified use occurs when the farm realty is converted to a nonagricultural endeavor. For example, farmland leased for the purpose of a shopping center would constitute a cessation of use.[43] Cessation also occurs if "[d]uring any period

[38] H.R. REP. No. 1380, *supra* note 2, at 22.
[39] I.R.C. § 2032A(c)(1).
[40] *Id.*
[41] I.R.C. § 2032A(c)(1)(A).
[42] *Id.* § 2032A(e)(1); H.R. REP. No. 1380, *supra* note 2, at 27.
[43] I.R.C. § 2032A(c)(1)(B).

of eight years ending after the date of the decedent's death and before the death of the qualified heir, there have been periods aggregating three years or more during which there was no material participation by the qualified heir or a member of his family in the operation of the farm or other business."[44] Thus, the concept of "material participation" is an important factor here, as well as in initially qualifying the decedent's estate.

The death of a "qualified heir" does not constitute a cessation of use with respect to that heir's interest.[45] However, if there is more than one "qualified heir" who has an interest in the farm realty, upon the death of one, the potential liability for recapture ceases only as to the proportionate interest of the deceased "qualified heir."[46] In addition, if "qualified real property" was left to two or more "qualified heirs" with *successive* interests in the property, the potential liability for recapture remains undiminished upon the first "qualified heir's death."[47]

3. Computation of the Recapture Tax

The maximum that can ever be recaptured is the tax savings that resulted from the application of section 2032A.[48]

The amount of estate tax benefit potentially subject to recapture with respect to any interest is the lesser of the following: 1) The excess of the estate tax liability, which would have been incurred had the special use valuation provision not been elected, over the actual estate tax liability for that interest based on the "special use" valuation;[49] 2) the amount realized on a sale or exchange of the interest over the "special use" value of the property;[50] and 3) the "highest and best use" value at the time of the recapture event over the "special use" value if that interest triggered recapture due to a cessation of a "qualified use."[51]

Only the first amount noted requires clarification. This amount is referred to in subparagraph 2032A(c)(2) as the

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[44] H.R. REP. No. 1380, *supra* note 2, at 26.
[45] *Id.*
[46] *Id.*
[47] *Id.*
[48] Case & Phillips, *supra* note 28, at 371.
[49] I.R.C. § 2032A(c)(2)(A)(i).
[50] *Id.* § 2032A(c)(2)(A)(ii).
[51] *Id.*

"adjusted tax difference attributable to such interest." It can be expressed by the following formula:

$$\frac{(X) \text{ times } (Y)}{(Z)}$$

where:

X is the total tax the estate deferred due to the "special use" valuation;[52]
Y is the excess of the interest's "highest and best use" value over the "special use" value;
Z is the excess of the "highest and best use" value over the "special use" value of all the "qualified real property."

Congress created three devices to ensure payment of the recaptured tax. First, the statute of limitations for the tax does not begin until the Internal Revenue Service is notified of the recapture-triggering event.[53] Second, section 6324B, enacted into law with section 2032A, provides that a lien in favor of the United States attaches to the "qualified real property" for the duration of the recapture period.[54] Third, the agreement that is filed with the estate tax return must contain the consent of each of the parties to the recapture tax provisions.[55] This consent imposes personal liability for any recapture tax due with respect to the "qualified heir's" interest in the "qualified real property."[56]

III. ESTATE TAX PLANNING

A. *Pre-mortem Planning*

Estate tax planning for the farmer should be initiated well in advance of death. If election of section 2032A is contemplated, measures should be taken to ensure the estate's qualification. Also, the best methods to hold and channel the farm assets to members of the decedent's family who will fulfill the section's requirements, must be chosen. Finally, the decision whether to elect section 2032A or section 6166 is faced by the estate with liquidity problems.

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[52] This amount is also known as the "adjusted tax difference with respect to the estate." *Id.* § 2032A(c)(2)(C).

[53] I.R.C. § 2032A(f)(1).

[54] *Id.* § 2032A(g).

[55] H.R. REP. No. 1380, *supra* note 2, at 27.

[56] *Id.*

1. General Considerations

The crucial decision is whether the estate should elect section 2032A. A farm located in a completely rural area already should be valued at its current actual use as farmland; the estate would only be hindered by section 2032A.[57] In contrast, since the value of a farm located near residential or industrial property is affected by nonagricultural factors, the valuations based on "highest and best use" and "special use" would be quite disparate. In this latter situation, however, election of section 2032A is not automatic. Consideration must be given to the costs of overseeing,[58] and to the restraint of disposing the "qualified real property" during the fifteen year recapture period.[59] The suggested test is whether the value of the "qualified real property" at its "highest and best use," or the amount of income it could produce if utilized in a nonagricultural manner, is greater than the net monetary return yielded under section 2032A.[60]

For two reasons, the decision whether to elect section 2032A should be made several years prior to the decedent's death. First, if the estate will have a problem meeting the 50 percent and 25 percent test, the decedent should make inter vivos gifts of the nonqualified property.[61] Thus, the percentage of qualifying property in the estate will rise.[62] As an added incentive for holding

[57] Case & Phillips, *supra* note 28, at 372.
[58] Keydel, *supra* note 3, at 11.
[59] Smith & Scrow, *supra* note 8, at 46.
[60] *Id.*
[61] Case & Phillips, *supra* note 28, at 372.
[62] To illustrate, a farmer owns the following assets:

	Value	Percentage
Two apartment buildings	$ 700,000	70%
Dairy farm	300,000	30%
	$1,000,000	100%

If the farmer makes an inter vivos gift of one apartment building worth $400,000, the estate's value would be $600,000. Consequently, the percentages of the farm assets would rise as follows:

		Percentages		
	Value	Required	Before Gift	After Gift
Total Farm Assets	$300,000	50	30	50
Farmland	$200,000	25	20	33⅓

"qualified real property" until death, the "special use" valuation rule does not apply for gift tax purposes.[63] Therefore, if a donor makes a lifetime transfer of his farm, the property is valued for gift tax purposes at its "highest and best use."[64] Second, to ensure "material participation" in the last eight years of the decedent's life, the members of his family should be encouraged to participate in the farming or ranching operation.[65]

2. Methods of Insuring Continuity of the Farming Operation

Choosing the proper method of holding the farm assets for the purposes of section 2032A is critical. Whether a corporation, partnership, or trust entity is selected,[66] the primary concern must be the continuation of the farm's operation for those children who elect farming for their livelihoods.[67] The corporate entity offers a distinct advantage; ownership is represented by shares of stock. Since only shares of stock are given, transfer of the operating farm to the children is facilitated.[68] While the partnership form has the advantage of ease of formation, its main drawback is that it dissolves upon the death of either partner.[69] Thus, objectives of continuity of operation and smooth intergenerational transfer would be lost.[70] In contrast, the revocable

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[63] RESEARCH INSTITUTE, *supra* note 33, at 34.

[64] *Id.*

[65] Case & Phillips, *supra* note 28, at 372.

[66] Congress indicated that a decedent's estate generally should be able to utilize the benefits of "special use" valuation where it holds the "qualifying real property" indirectly through its interest in a partnership, corporation, or trust. However, two requirements must be met: 1) The business in which such property is used constitutes a closely held business as defined in section 6166; and 2) the real property would qualify for "special use" valuation if it were held directly by the decedent. H.R. REP. No. 1380, *supra* note 2, at 24. Section 6166(b)(1) defines "interest in a closely held business." A partnership interest is an "interest in a closely held business" if 20 percent or more of the total capital interest in such partnership is included in determining the gross estate of the decedent, or if such partnership had 15 or fewer partners. Stock in a corporation is an "interest in a closely held business" if 20 percent or more in value of the voting stock of such corporation is included in determining the gross estate of the decedent, or if such corporation had 15 or fewer shareholders. Note that a trust would qualify if its corpus consisted of a partnership or corporate interest that also qualifies as an "interest in a closely held business."

[67] This is the underlying objective of section 2032A. *See* text accompanying note 2 *supra*.

[68] Kirby, *Choosing the Best Method of Holding Farm Assets Is Integral Part of Premortem Planning*, EST. PLAN., Autumn 1976, at 53.

[69] Treas. Req. § 1.708-(b)(1)(i)(a) (1956).

trust guarantees a smooth inter-generational transfer whenever the decedent's wife does not elect her statutory forced share of the estate.[71]

Once the method of holding the farm assets has been chosen, planning should ensure that recapture of the tax is a remote possibility. Through the farmer's will, the "qualified real property" should be channeled to those members of the decedent's family who will fulfill the requirements of section 2032A.[72]

One foreseeable problem is the possibility that the decedent's spouse will elect against the will for her statutory share of the estate and later sell the "qualified real property" to a nonfamily member.[73] Therefore, the sale would trigger recapture, and the benefits of section 2032A would be forfeited.[74] A plausible solution would be the irrevocable trust since it cannot be defeated by the surviving spouse. However, the effectiveness of this device is illusory: Section 2032A does not apply to what is essentially a gift.[75] Fortunately, two devices may provide a solution to this problem. One is a waiver from the farmer's spouse specifying that she is waiving her right of election.[76] The other is a will contract specifying that she will only sell the "qualified real property" to members of her family.[77] However, since both devices are contractual arrangement, two disadvantages exist: 1) The spouse may or may not agree to the contract; and 2) the court may or may not grant specific performance as a remedy for breach. Regardless, the members of the surviving spouse's family, who wish to continue

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[70] Kirby, *supra* note 68, at 55.

[71] U.P.C. 2-201. The decedent's spouse can defeat the revocable trust because it constitutes a "transfer to the extent that the decedent retained at the time of death a power, either alone or in conjunction with any other person, to revoke or to consume, invade or dispose of the principal for his own benefit." *Id.* 2-202(1)(ii).

[72] Smith & Scrow, *supra* note 8, at 56.

[73] *See* U.P.C. 2-201. The corresponding Colorado provision allows a one-half elective share. COLO. REV. STAT. § 15-11-201 (1973).

[74] *See* text accompanying note 40 *supra.*

[75] *See* Treas. Reg. 25.2512-1 and text accompanying notes 63 and 64 *supra.*

[76] U.P.C. 2-204: "The rights of election of a surviving spouse . . . may be waived, wholly or partially, before or after marriage, by a written contract, agreement, or waiver signed by the party waiving after fair disclosure."

[77] *Id.* 2-701:

> A contract to make a will or devise, or not to revoke a will or devise, or to die intestate . . . can be established only by (1) provisions of a will stating material provisions of the contract; (2) an express reference in a will to a contract and extrinsic evidence proving the terms of the contract; or (3) a writing signed by the decedent evidencing the contract. . . .

the farming operation and to avoid recapture, should attempt to purchase or lease the "qualified real property" from the surviving spouse.[78]

3. The Estate with Liquidity Problems

Another crucial factor in the decision to elect section 2032A involves its interaction with section 6166. In conjunction with section 2032A, section 6166 was enacted to ameliorate the estate tax problems of farmers and ranchers. Both sections can be elected simultaneously.[79] Section 6166 permits the executor to elect to pay by installments the estate tax over a fifteen year period.[80] The first installment may be deferred for five years; during this period only interest on the unpaid tax is due.[81] In addition, a special interest rate of four percent is charged on the first $345,800 in deferred estate tax, reduced by the unified credit allowable under section 2010(a).[82] However, the value of the farm assets must exceed 65 percent of the value of the adjusted gross estate before section 6166 can be elected.[83]

If the "special use" value is elected under section 2032A, the estate may forfeit the beneficial provisions of section 6166.[84] Section 6166(b)(4) provides that the value used to determine the federal estate tax, whether it be "highest and best use" or "special use" value, is the value used for purpose of the sixty-five percent requirement. Consequently, if the special use value of the farm realty significantly reduces the value of the total farm assets, the farm's value may not exceed sixty-five percent of the value of the adjusted gross estate.[85] Such failure to satisfy the sixty-five percent requirement forces a difficult decision since election of one of these code sections precludes the election of the

[78] *See* I.R.C. § 2032A(c)(1)(A).

[79] RESEARCH INSTITUTE, *supra* note 33, at 49.

[80] I.R.C. § 6166(a)(3).

[81] *Id.* §§ 6166(a)(3), (f)(1).

[82] *Id.* § 6601(j). The figure $345,800 represents the liability of a taxable estate of $1,000,000 pursuant to the tax rate schedule in section 2001(c). The interest rate of 4 percent is quite a bargain. Section 6621(a) specifies the general interest rate of 9 percent per annum, or a rate based on 90 percent of the average prime rate quoted by commercial banks to large business.

[83] *Id.* § 6166(a)(1).

[84] Rosen, *New Tax Savings Opportunities in Post-mortem Planning Provided by Tax Reform Act of 1976,* 18 TAX. FOR ACCOUNTANTS 86, 88.

[85] *Id.*

other. The basic test, therefore, is whether the estate's liquidity problems mitigated under section 6166 outweighs the tax avoided under section 2032A.

B. *Post-mortem Planning*

To avert recapture of the estate tax, the estate's personal representative and his counsel must periodically supervise the administration of the "qualified heir's" interest in the farm realty. This supervision, necessarily, must continue throughout the entire fifteen year recapture period. Not only do they have a duty to inform each "qualified heir" of his potential recapture tax liability,[86] but also a duty to discourage premature disposition of the "qualified heir's" interest. Therefore, the severe tax consequences of a premature disposition cannot be overemphasized. Moreover, the estate's counsel should anticipate, with effective tax planning, IRS audits; negligent planning may result in recapture.

1. Effects of Premature Disposition or Cessation

The tax consequences of a premature disposition of a "qualified heir's" interest or cessation of a "qualified use" of the "qualified property" can be disastrous. Section 2032A(c)(5) states that the recapture tax is due and payable on the day ending six months after the disposition or cessation. Interest is charged on the recaptured tax only on the period beginning six months after the day of disposition or cessation and ending on the day of the tax payment.[87] However, the recapture tax is not payable in installments. Section 6166(h)(1), the general installment payment provision, does allow installment payment for deficiencies in tax imposed by section 2001, the general estate tax imposition provision. However, the recapture tax is not imposed by section 2001, but by section 2032A(e)(1).[88] Therefore, the recapture tax is not payable in installments.

Another unfavorable consequence of premature disposition involves the election of section 6166 by an estate with liquidity problems. If the "qualified heirs" dispose of one third or more of the farm interest, then the extension of time for payment of estate

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[86] Kirby, *supra* note 23, at 100.

[87] *See* I.R.C. §§ 6601(a), 2032A(c)(5).

[88] The new section states "there is hereby imposed an additional estate tax."

tax ceases to apply.[89] Any unpaid portion of estate tax payable in installments must be paid upon notice and demand from the Internal Revenue Service.[90]

Also, there will be a capital gains tax on any disposition of a "qualified heir's" interest.[91] This capital gain is the difference between the amount realized from a sale and the "qualified heir's" basis in the "qualified property."[92] Consequently, the "qualified heir" must decide how to report this gain. Under section 61(a)(3) the entire gain must be reported in the year of sale. Under section 453(b) only a portion of the gain is reported in any tax year, based on the installment payments actually received in that year.[93]

If the installment method under section 453 is elected, then the payments received from the purchaser cannot exceed thirty percent of the sale price in the year of disposition.[94] Due to this limitation, the payments received in the year of sale probably will be insufficient to pay the recaptured tax caused by the disposition.[95] If the capital gain is reported pursuant to section 61, then the purchase payments can be arranged to cover the recaptured tax liability. However, because the entire gain is reported in one

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[89] I.R.C. § 6166(g)(1)(A).

[90] *Id.*

[91] *See* I.R.C. § 61(a)(3).

[92] Basis will be determined by section 1023, enacted into the Internal Revenue Code under the 1976 Tax Reform Act. The section provides that the basis of the property in the hands of the "qualified heir" is the same as the decedent's basis, increased by certain adjustments. The fact that the transferee *may* have to pay the tax due to recapture does not increase the transferee's basis because of the tax's contingent nature. *See Columbus & Greenville R.R. Co.*, 42 T.C. 834, 848 (1964). Presumably, an increase would be allowed where the transferee actually pays the tax subject to recapture. *See* Case & Phillips, *supra* note 28, at 371.

[93] A person "may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit, realized or to be realized when payment is completed, bears to the total contract price." I.R.C. § 453(a).

[94] I.R.C. § 453(b)(2)(B).

[95] For example, assume the following:

Sales Price of Interest	$500,000
Basis	200,000
Gain	$300,000

To elect section 453, the purchase payments cannot exceed 30 percent of $500,000, or $150,000, in the year of sale. Therefore, the "qualified heir" will be forced to finance any recapture tax in excess of $150,000.

tax year and thus is subject to higher tax brackets, additional income tax liability is incurred.

2. IRS Audits and Determinations

An IRS audit of an estate electing section 2032A will focus primarily on the section's valuation and recapture provisions. Effective planning is impossible for the former but not for the latter. Due to its subjectivity, valuation is always subject to an IRS attack. However, probable areas of IRS challenge warrant mentioning. First, because the "special use" value cannot decrease the "highest and best use" value by more than $500,000,[96] the agent can create additional estate tax liability. The gross estate will be increased to the extent either the "highest and best use" value is increased or the "special use" value is decreased.[97] Second, the agent could contend that the value of the farm asset fails to satisfy the fifty percent and twenty-five percent tests.[98] Such a determination would have the same effect as a recapture of the estate tax saved.[99]

Effective planning can preclude IRS determinations that result in recapture of the estate tax avoided pursuant to section 2032A. A determination either that "material participation" is lacking or the farming activity is primarily a "hobby" will result in recapture. The germane issue common to both determinations is whether the "qualified heir" is engaged in a "trade or business."

Section 2032A(c)(7)(B) provides that cessation of a "qualified use" occurs if there is no "material participation" by a "qualified heir" or "member of his family" in the operation of the farm.[100] The lack of "material participation" must involve periods aggregating three years or more during any eight-year period within fifteen years of the decedent's death.[101] As noted, "material participation" is determined by section 1402 which re-

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[96] *See* text accompanying note 33 *supra.*

[97] However, additional estate tax liability would occur only when the two values are adjusted after the maximum of $500,000 had already been reached.

[98] *See* text accompanying notes 15 and 16 *supra.*

[99] However, interest would accrue from the date the estate tax was due rather than when the recapture tax was due. *See* I.R.C. §§ 6601(a), 6151(a), 6075(a), and text accompanying note 87 *supra.*

[100] *See* text accompanying note 44 *supra.*

[101] *Id.*

lates to net earnings from self-employment.[102] The issue of whether the "qualified heir" materially participates usually arises when he leases the farm to a nonfamily member.[103] The committee report states unequivocably that mere passive rental of the farm does not constitute "material participation."[104] This statement is true because of the following general rule: income and expenses attributable to rent from real estate are not considered in determining net earnings from self-employment.[105] Therefore, the requisite "trade or business" involvement by the "qualified heir" is lacking.[106]

However, the "qualified heir" may still lease the farm and meet the "material participation" requirement under certain circumstances. The rental arrangement[107] must provide that the "qualified heir" shall materially participate in the "production"[108] or "management of production"[109] of the farm products. Fortunately, the IRS has delineated four objective tests of "material participation." The "qualified heir" or "member of his family" is deemed to materially participate in the "trade or business" of farming if:

> 1. he does any three of the following: a) pay for at least half of the direct costs of producing the crop; b) provides at least one half the equipment and livestock used in producing the crop; c) advises and consults with the tenant periodically; or d) inspects the production activities periodically;[110]
> 2. he takes a substantial part in management decisions that affect the success of the farm activity;[111]
> 3. he works 100 hours or more over a period of 5 weeks or more in activities associated with crop production;[112] or
> 4. he does things, when considered in the aggregate, which demonstrate a material or substantial involvement in the production of the farm goods.[113]

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102 *See* text accompanying note 30 *supra*.
103 FARMER'S TAX GUIDE, PUB. 225 (1977), at 54 [hereinafter cited as GUIDE].
104 H.R. REP. NO. 1380, *supra* note 2, at 23.
105 GUIDE, *supra* note 103, at 54.
106 *See* note 30 *supra*.
107 Treas. Reg. § 1.1402(a)-4(b)(3)(i) (1976).
108 *Id.* § 1.1402(a)-4(b)(3)(ii) (1976).
109 *Id.* § 1.1402(a)-4(b)(3)(iii) (1976).
110 GUIDE, *supra* note 103, at 54. *See* Rev. Rul. 57-58, 1957-1 CB 270, 271. Treas. Reg. § 1.1402(a)-4(b)(3), (4) is the primary source for the Farmer's Tax Guide's Information on "material participation."
111 GUIDE, *supra* note 103, at 54.
112 *Id.* at 55.
113 *Id.*

Using these guidelines, the estate's personal representative or his counsel can convert *passive* rental arrangements into *active* participation in the "trade or business" of farming. In borderline situations, however, they should timely document all facts indicating "material participation" in anticipation of an IRS challenge.

There exists another method by which the IRS may force recapture through the "trade or business" concept. The farm operation must be a "trade or business" before it is considered a "qualified use" of a farm.[114] Section 183(a) states that if any "activity is not engaged in for profit," then no deductions in excess of that activity's income is allowed. Section 183(c) defines an "activity not engaged in for profit" as one other than those activities under section 162 which permits a deduction incurred in carrying on a "trade or business." Therefore, if the IRS agent determines that the farming operation is not engaged in for profit by the "qualified heir," e.g., it is a hobby, the requisite "trade or business" of farming for a "qualified use" ceases. Consequently, the agent would disallow the farm's losses under section 183(a) and impose the recapture tax under section 2032A(c)(1)(B).

Careful tax planning avoids such a result. Section 183(d) provides a rebuttable presumption that the activity is engaged in for profit if in two years out of any five year period the activity produces a net profit. With an accountant's advice, the "qualified heir" can produce "accounting" net profits. If the "qualified heir" computes income under the cash method of accounting, these net profits are accomplished by postponing deductions and accelerating income items in a particular tax year.[115] Furthermore, Treasury regulations identify objective factors for determining the "qualified heir's" subjective intent to make a profit.[116]

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[114] I.R.C. § 2032A(b)(2).

[115] *See* I.R.C. §§ 451, 461.

[116] Treas. Reg. 1.183-2(b)(1)-(9) (1972). These factors are:

1. the taxpayer's history of income or losses with respect to the activity;
2. the amount of occasional profits, if any, which are earned;
3. the cause of the losses;
4. the success of the taxpayer in carrying on other similar or dissimilar activities;
5. the financial status of the taxpayer;
6. the time and effort expended by the taxpayer in carrying on the activity;
7. the expertise of the taxpayer or his advisors;
8. the manner in which the taxpayer carries on the activity;

Many of these objective factors can be manipulated to remove any doubt as to the heir's bona fide profit intent. For example, one factor is the manner in which the "qualified heir" carries on the activity.[117] Therefore, the "qualified heir" should conduct the farm operation in a businesslike manner and maintain complete and accurate books and records; a profit intent is thus indicated.

CONCLUSION

For those who qualify and are willing to hold the farm property for fifteen years after the decedent's death, the new law offers substantial estate tax savings. More importantly, section 2032A ensures the continuation of the American family farm in two ways. First, farm assets need not be sold to pay the estate tax. Second, family members are encouraged to participate in farming before and after the decedent's death. Valuable farming knowledge is thereby passed from one generation to the next. In essence, Congress has drafted legislation aimed primarily at social engineering rather than revenue raising.

For the personal representative and his counsel, the new law does not offer a specious challenge. Certainly, the law is complex with myriad references to other Code sections. However, the law's true challenge arises from the exacting decisions required. The crucial decision is whether section 2032A should be elected. Once committed, the personal representative must cope with both the farm family and the Internal Revenue Service for fifteen years to avoid the spectre of recapture.

Kevin O'Shaunessy O'Brien

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9. expectation of profit by the taxpayer;
10. expectation that assets used in the activity may appreciate in value; and
11. elements of personal pleasure or recreation.

[117] *See* note 116, *supra*.

Shaffer v. Heitner: A SINGLE TEST FOR STATE COURT JURISDICTION

INTRODUCTION

In the recent decision of *Shaffer v. Heitner*,[1] the United States Supreme Court significantly changed the test for state court jurisdiction. The Court ended the traditional distinction between actions against persons and actions against property. It asserted that all state court jurisdiction must be based on the test of fairness to the defendant, as delineated in *International Shoe Co. v. Washington*.[2]

Prior to the ruling in *Shaffer*, a foreign defendant who did not have sufficient contacts with the forum state was not subject to *in personam* jurisdiction in that state.[3] However, the plaintiff was not without recourse. If the defendant owned property in the forum state, that property could be attached in a *quasi in rem* action, giving the state jurisdiction over that property in answering any claims against the unavailable property owner.[4] The defendant's property was the basis for jurisdiction and the means to satisfy any adverse judgment. There was no concern for the defendant's contacts with the forum state.

The effect of the ruling in *Shaffer* is to prohibit *quasi in rem* actions against property if, after an examination, there are no ties between the defendant property owner, the forum state, and the nature of the litigation. A state no longer has automatic jurisdiction over property within its borders. Instead, it must have jurisdiction over the property owner, and that determination rests in *International Shoe*.[5]

This new focus on the property owner does not preclude the possibility that the presence of the defendant's property in the forum state may have a bearing on the existence of jurisdiction over him. But, the property has significance only in evidencing ties and contacts between the defendant and the forum state.[6] Also, the presence of the defendant's property may have no bear-

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[1] 433 U.S. 186 (1977).
[2] 326 U.S. 310 (1945).
[3] *See* text accompanying notes 24-28 *infra*.
[4] Shaffer v. Heitner, 433 U.S. 186, 199 (1977).
[5] *Id.* at 207-08.
[6] *Id.*

ing on the existence of jurisdiction if that property is unrelated to the cause of action.

In applying this new test to the facts in *Shaffer*, the Supreme Court determined that nonresidents of Delaware were not subject to that state's jurisdiction, even though they owned property within the state. This lack of jurisdiction reflected the absence of any tie between the owners' property contact with the state and the nature of the litigation.[7] Furthermore, the attachment statute, which brought the property before the Delaware court, did not comport with the *International Shoe* test.[8]

I. TRADITIONAL BASIS FOR JURISDICTION

A. Pennoyer v. Neff[9]

Of major significance in *Shaffer* was the demise of the traditional justifications for state jurisdiction to adjudicate. Much of the traditional theory was enumerated by Justice Field in the 100 year old decision of *Pennoyer v. Neff*. Under *Pennoyer* each state had jurisdiction over all persons and all property within its borders. Conversely, no state had jurisdiction over persons and property outside of its borders.[10] However, if a person outside of the state's borders left property within the state, the state had jurisdiction over the property in determining any claims against the unavailable property owner.[11] Such *quasi in rem* actions were direct against the property and indirect against the property owner.[12] Jurisdiction over the property was automatic as long as the property was brought before the court by attachment or sequestration.[13]

One important characteristic of *quasi in rem* actions was that the satisfaction of an adverse judgment was limited to the value

[7] *Id.* at 213-16.

[8] *Id.* at 213-14.

[9] 95 U.S. 714 (1877). The Court in *Shaffer* overruled *Pennoyer* to the extent that it was inconsistent with its new holding. 433 U.S. at 212 n.39.

[10] 95 U.S. at 722 (1877).

[11] *Id.* at 723.

[12] Shaffer v. Heitner, 433 U.S. 186, 199-200 (1977). As a result, courts did not require personal service on the property owner.

[13] In *Pennoyer* the property was not properly attached. Thus, the court could not proceed *quasi in rem* against the land because it was not before the court. 95 U.S. at 727. Since the ruling in *Pennoyer*, the Supreme Court has made it necessary to augment attachment with the most reasonably available method of personal notice. *See*, Schroeder v. City of New York, 371 U.S. 208 (1962).

of the jurisdictional property.[14] The property owner could appear specially to defend the property, without incurring personal liability, because the action remained against the property.[15]

Of additional significance in *Shaffer* was the divisibility of *quasi in rem* actions into two categories, depending on the relationship the property had to the nature of the litigation.[16] In the first category were actions where the attached property provided the basis for jurisdiction and also was specifically related to the underlying claim. One example of this first category was attachment of mortgaged property in a foreclosure action.[17] The second category embodied situations where the attached property provided only the basis for jurisdiction. The underlying claim had no relation to the attached property.[18] The *quasi in rem* action in *Shaffer* fell within this second category.[19] There the underlying claim was the supposed breach of fiduciary duties by the directors and officers of Greyhound Corp.[20] The sequestered personal stock property of the defendants, the basis of Delaware's assertion of jurisdiction, was wholly unrelated to a determination of any breach of their corporate responsibilities.[21]

B. *From* Pennoyer *to* International Shoe

The history of state court jurisdiction following the *Pennoyer* concepts of power over persons and property was marked by oblique attempts to expand these jurisdictional confines to meet the needs of an increasingly mobile society. As the country developed, it was no longer practical to restrict state jurisdiction to

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[14] Shaffer v. Heitner, 433 U.S. 186, 199 (1977).

[15] Because the action is against the property, *res judicata* does not apply if the plaintiff seeks to bring the suit in another jurisdiction where the owner is subject to *in personam* liability. *See* Bruns Bros. v. Central R.R., 202 F.2d 910 (2d Cir. 1953). Partly due to this reason, some states allow the owner to appear only *in personam* in defense of his property. This prevents a bifurcation of the suit and potential double liability. *See*, DEL. CODE tit. 10, § 366 (1974).

[16] Folk & Moyer, *Sequestration in Delaware, a Constitutional Analysis*, 73 COLUM. L. REV. 749, 782-89 (1973) [hereinafter cited as Folk & Moyer].

[17] Other typical *quasi in rem* actions falling within this first category include clouds on title, enforcement of judicial liens, and establishment and determination of rights in a trust. *Id.* at 782.

[18] *Id.* at 784.

[19] 433 U.S. at 208-09.

[20] *See* text accompanying note 40 *infra*.

[21] 433 U.S. at 213. The Court wrote that the "property is not the subject matter of this litigation, nor is the underlying cause of action related to the property."

persons and property within state boundaries. As a consequence, the courts developed encompassing legal fictions of implied consent and implied presence, thus creating jurisdiction compatible with *Pennoyer.*[22] Similarly, the state legislatures enacted long arm statutes to obtain jurisdictions over nonresident auto drivers who caused damage in the state.[23] In these situations, the state had no real physical power over the foreign defendants, as required under *Pennoyer,* but it was necessary that such defendants be subject to suit for their wrongs.

In response, the Supreme Court in *International Shoe Co. v. Washington*[24] expanded and redefined the conceptual basis for state court jurisdiction. No longer was the focus on physical power over persons within the state's boundaries. Instead, the Court ruled that the jurisdictional test for *in personam* jurisdiction rested on a finding of minimum contacts between the defendant and the forum state.[25] Thus, no state had the power to make "binding a judgment *in personam* against any individual or corporate defendant with which the state ha[d] no contacts ties or relations."[26] Foreign defendants were subject to suit only if they had sufficient contacts with the forum.[27] The Court had little concern for the *Pennoyer* concept of the power of the state.[28] The rationale for this new ruling was based on expanded notions of due process fairness.[29]

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[22] Hutchinson v. Chase & Gilbert, 45 F.2d 139, 141 (2d Cir. 1930). *See,* Kurtland, *The Supreme Court, The Due Process Clause and In Personam Jurisdiction of State Courts—From Pennoyer to Denckla: A Review,* 25 U. CHI. L. REV. 569, 577-86 (1958).

[23] "The advent of automobiles, with the concomitant increase in the incidence of individuals causing injury in states where they were not subject to *in personam* actions under *Pennoyer,* required further moderation of territorial limits on jurisdictional power." Shaffer v. Heitner, 433 U.S. 186, 202 (1977). *See,* Hess v. Pawloski, 274 U.S. 352 (1927).

[24] 326 U.S. 310 (1945).

[25] *Id.* at 316.

[26] *Id.* at 319.

[27] *See generally,* McGee v. International Life Ins. Co., 255 U.S. 220, 223 (1957) (Texas life insurance company subject to suit in California even though its only contact with the state was a policy with a California resident); Buckeye Boiler Co. v. Superior Court, 71 Cal. 2d 893, 458 P.2d 57, 80 Cal. Rptr. 113 (1969) (The Court said that jurisdiction reflected a balancing of inconveniences to the nonresident defendant versus the interests of the state and the local plaintiff); Gray v. American Radiator and Standard Sanitary Corp., 22 Ill. 2d 432, 176 N.E.2d 761 (1961) (Parts manufacturer was liable in Illinois because it was inferrable that products which incorporated its parts were used in Illinois).

[28] 326 U.S. at 316.

[29] The Court in *International Shoe* wrote:

Historically the jurisdiction of courts to render judgment *in personam* is

One major aspect of the old *Pennoyer* rationale which remained untouched by the *International Shoe* ruling was the state's jurisdictional power over property within its borders. The Court retained the old premise that *quasi in rem* actions were against property and not the property owner. If the property law lay within the state it was subject to attachment and sale to answer any claim against the property owner. There was no concern for the property owner's minimum contacts with the forum state, even though he may have lacked such contacts. One judge recently referred to this situation as an "irrational bifurcation of *International Shoe.*"[30]

The continued validity of *quasi in rem* actions against property often resulted in great unfairness to the property owner. The injustice was most visible in two situations. First, if the property was intangible, its situs was often arbitrarily attached to the forum state through the use of legal fictions. Such fictions usually operated without the knowledge or control of the property owner. An illustrative fiction was the *Harris v. Balk* doctrine[31] which allowed a creditor's debt to be attached wherever the debtor could be served. A similarly fetching situation occurred in *Shaffer v. Heitner.* There a Delaware statute placed the situs of all stock in Delaware corporations in Delaware,[32] regardless of the location of the stock certificate or stockholder's domicile. The remaining states place situs where the stock certificate lies.[33] These varying

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> grounded on their de facto power over the defendant's person . . . . But now that the *capis ad respondendum* has given way to personal service of summons or other form of notice, due process requires only that in order to subject a defendant to a judgment *in personam,* if he be not present within the territory of the forum, he have certain minimum contacts . . . .

326 U.S. at 315.

[30] Jonnet v. Dollar Savings Bank, 530 F.2d 1123, 1130, 1132-33 (3d Cir. 1976) (Gibbons, J., concurring).

[31] 198 U.S. 215 (1905). In *Harris,* Harris and Balk were residents of North Carolina. Epstein was a resident of Maryland. Epstein had a claim against Balk but had no way to serve Balk in Maryland. However, Epstein was able to obtain jurisdiction by attaching an unrelated debt which Harris owed to Balk. The attachment occurred when Harris was present in Maryland (debt attaches to the debtor). Later, Balk was prevented from collecting the debt owed to him by Harris because it had already been used to satisfy Epstein's claim against Balk. Such a ruling is unlikely under *Shaffer* because the focus of jurisdiction in Maryland would be on Balk, not the location of the debt (Balk's property), and Balk had no other contacts with the forum state. *See,* 433 U.S. at 212 n.39.

[32] *See* text accompanying notes 62-64 *infra.*

[33] *Id.*

rules could have resulted in attachment of the stock in two jurisdictions at once.[34]

The other injustice occurred in the use of *quasi in rem* actions of the second category, where the attached property was not the subject of the controversy. Fairness to the property owner was often subverted because of the lack of any meaningful nexus between the basis for jurisdiction (the presence of property) and the controversy. If the property was attachable in the state, the owner was subject to suit to the extent of the value of the property.[35] The nature of the suit was not restricted to obligations arising out of the property. Thus, if Jones lived in state B and owned property in state C, another resident of state B conceivably could sue Jones in state C on a matter unrelated to the attached property.

II. *Shaffer v. Heitner*

Heitner, a nonresident of Delaware, owned one share of stock in Greyhound Corporation.[36] Greyhound was incorporated in Delaware but had its principal place of business in Arizona.[37] In 1974 Heitner filed a stockholder's derivative suit in Delaware[38] against Greyhound,[39] a subsidiary, and twenty-eight present and former directors and officers of Greyhound. The complaint alleged, in part, that the directors and officers were liable individually for breaching their fiduciary duties. The breach occurred when they directed the corporation in activities which caused the corporation to become subject to criminal fines and civil damages.[40]

None of the directors or officers was a resident of Delaware, nor were any of them at any time physically within Delaware.[41]

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[34] Note, *U.S. Industries Inc. v. Gregg*, 38 U. PITT. L. REV. 789, 806-07 (1977).

[35] *See* text accompanying notes 11-15 *supra*.

[36] Shaffer v. Heitner, 433 U.S. 186, 189 (1977).

[37] *Id.*

[38] *Id.* The action was brought in the Court of Chancery, New Castle County, Delaware on May 22, 1974.

[39] In a stockholder's derivative suit, the corporation is a named defendant, resulting from its failure to assert the claim on its own behalf. This failure makes the corporation an indispensable party. *See*, Geer v. Mathieson Alkali Works, 190 U.S. 428 (1903).

[40] Greyhound was found guilty in a criminal suit of a violation of the Sherman Antitrust Act. The court levied fines totalling $600,000 against Greyhound and a subsidiary, Greyhound Lines. United States v. Greyhound Corp., 363 F. Supp. 525 (N.D. Ill. 1973), *aff'd*, 508 F.2d 529 (7th Cir. 1974). In a related civil suit, a judgment of $13,146,090, plus attorneys' fees, was entered against Greyhound. Mt. Hood Stages, Inc. v. Greyhound Corp., 555 F.2d 687 (9th Cir. 1977).

[41] The majority wrote that Heitner "did not allege and does not now claim that the appellants have ever set foot in Delaware." 433 U.S. at 213.

However, twenty-one of them did own stock in Greyhound Corporation, and, under Delaware law, all stock issued by a Delaware corporation had its ownership situs in that state.[42] Based on this presence of property in Delaware, Heitner successfully moved to have the Greyhound stock of these twenty-one defendants sequestered.[43] Under the statute, if the defendants had wished to defend their property they could have done so only by making a general appearance in Delaware.[44]

The twenty-one defendants did not attempt to defend on the merits of the controversy.[45] Instead, they appeared specially in a Delaware Court of Chancery and moved to vacate the sequestration of their stock. They contended that Delaware did not have jurisdiction to adjudicate the controversy because they, the defendants, did not have personal contacts with the state, as required under the test of *International Shoe Co. v. Washington.*[46]

Both the Court of Chancery and the Delaware Supreme Court[47] rejected the defendants' jurisdictional attack. Each court ruled that Heitner had instituted a *quasi in rem* action against the sequestered stock property.[48] Thus, the fact that Delaware did not have jurisdiction over the defendants individually was irrelevant because the state had proper jurisdiction over their property.[49]

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[42] DEL. CODE tit. 8, § 169 (1974). *See,* text accompanying notes 62-66 *infra.*

[43] DEL. CODE tit. 10 § 366 (1974). Sequestration in Delaware is the equitable counterpart to attachment at law. Both may be used to obtain *quasi in rem* or *in rem* jurisdiction. *See,* Sands v. Lefcourt Realty Corp., 35 Del. Ch. 340, 344, 117 A.2d 365, 367 (1955).

[44] Section 366 provided if the defendant did not appear *in personam* the court had power to use the sequestered property in satisfaction of a default judgment. If the defendant did appear, then the judgment was personal and not limited to the value of the sequestered property. *See generally,* Folk and Moyer, *supra* note 16, at 789-94.

[45] Since the remaining seven directors and officers owned no property in Delaware the actions against them were apparently dismissed for failure to secure jurisdiction. 433 U.S. at 214.

[46] They also contended that the sequestration was *ex parte,* denying them procedural due process. *See,* Fuentes v. Shevin, 407 U.S. 67 (1972) (the defendant had to receive notice and a right to be heard prior to any taking of her property). Here, however, the Delaware Supreme Court held that the sequestration was an extraordinary situation which justified the *ex parte* taking. Greyhound v. Heitner, 361 A.2d 225, 231 (Del. 1977). *See,* Sniadach v. Family Finance Corp., 395 U.S. 337, 339 (1969) (extraordinary situations may justify a taking prior to notice and hearing).

[47] *See,* Greyhound v. Heitner, 361 A.2d 225, 229 (Del. 1977).

[48] 361 A.2d at 229.

[49] The Delaware Supreme Court wrote:

There are significant constitutional questions at issue here but we say at once

On appeal, the United States Supreme Court reversed. The Court applied the jurisdictional test of *International Shoe Co. v. Washington,* as the defendants had urged. It rationalized its ruling on the newly adopted premise that all actions *quasi in rem* were really actions to determine *persons'* interests in property.[50] Such actions were against the property owners not the property. Since the action in *Shaffer* was against the officers and directors and not the stock, jurisdiction existed only if Delaware could have exerted jurisdiction over them personally. The effect of this holding shifted the focus away from the state's power over the nonresident's property in the state to a determination of sufficient ties among the defendant, the state, and the litigation.[51] The Court in *Shaffer* emphasized, contrary to traditional theory, that the property owner was the real party in interest, and jurisdiction over his interests in property within the state was permissible only when he could be brought properly before the court.

Since Delaware had been concerned only with the presence of the defendants' property when it took jurisdiction,[52] it had acted, said the Court, contrary to the *International Shoe* test. Furthermore, in re-examining the facts in light of *International Shoe,* the Court did not find sufficient ties among the defendants, the state, and the litigation to permit the controversy to be tried in Delaware.[53]

III. ANALYSIS OF THE HOLDING IN *Shaffer v. Heitner*

A. *Narrow Approaches Under Delaware Law*

Considering the long case history which the decision in

> that we do not deem the rule in *International Shoe* to be one . . . . The reason of course, is that the jurisdiction under § 366 remains . . . *quasi in rem* founded on the presence of the capital stock here, not on prior contacts by the defendants with the forum.

Id.

[50] 433 U.S. at 207. The Court did not rule on the constitutionality of the defendants' claim that the sequestration was a violation of procedural due process. *See* note 46 *supra.* For an analysis of potential procedural due process issues in attachment to gain jurisdiction, see Note, *Quasi In Rem Jurisdiction and Due Process Requirements,* 82 YALE L. REV. 1023 (1973).

[51] 433 U.S. at 204. This decision followed several recent lower court opinions. *See,* U.S. Indus. v. Gregg, 540 F.2d 142 (3d Cir. 1976), *cert. denied,* 433 U.S. 908 (1977); Jonnet v. Dollar Savings Bank, 530 F.2d 1123, 1130 (3d Cir. 1976) (Gibbons, J., concurring).

[52] 433 U.S. at 213. "The Delaware courts based their assertion of jurisdiction in this case solely on the statutory presence of appellants' property in Delaware."

[53] *Id.* at 213-16. *But see,* text accompanying notes 94-95 *infra.*

Shaffer overturned, a serious question arises as to whether the Court needed to take such pervasive action. It is maintainable that narrower avenues could have brought equal results.[54]

1. The Nature of Delaware's Sequestration Statute

In the first instance, the Delaware courts rejected the defendants' jurisdictional challenge because the action was *quasi in rem,* due to the sequestration of the defendants' stock under title 10, section 366 of the Delaware Code.[55] The Supreme Court in *Shaffer* accepted the *quasi in rem* label and went on to attack the general soundness of such actions.[56] However, section 366 resulted in litigation which lacked fundamental characteristics of traditional *quasi in rem* actions.

In describing the general nature of *quasi in rem* actions, Justice Marshall in *Shaffer* wrote that the judgment in such suits was "limited to the property that supports jurisdiction and does not impose a personal liability on the property owner since he is not before the court."[57] Section 366 had a quite different effect. The statute did not limit judgments to the value of the property because the owner could defend his property only by submitting to full *in personam* liability.[58] It is significant that in its earlier Jurisdictional Statement the Court emphasized that section 366 was an assertion of *in personam* jurisdiction, causing *International Shoe* to control.[59] Furthermore, the Court suggested that the Delaware statute was not a legitimate exercise of *quasi in rem* jurisdiction because it did not afford the owner of the property an unconditional opportunity to defend the property.[60]

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[54] Because jurisdiction involves substantive due process issues the Supreme Court normally refrained from making broad rulings when narrower avenues existed. *See,* Ashwander v. Valley Authority, 297 U.S. 288, 345 (1936) (Brandeis, J., concurring).

[55] Del. Code tit. 10, § 366 (1974).

[56] 433 U.S. at 196.

[57] *Id.* at 199.

[58] It is true that in the initial sense section 366 is *quasi in rem* because jurisdiction rests on the sequestration of the property, not control over the defendant. But any defense of the property is not *quasi in rem.*

[59] Shaffer v. Heitner, 429 U.S. 813, Jurisdictional Statement, No. 75 1812, at 13 (October term, 1976) (not for general publication) [hereinafter cited as Jurisdictional Statement]. Even in the Court's full opinion it recognized Delaware's motive by writing, "the express purpose of the Delaware sequestration procedure is to compel the defendant to enter a personal appearance." 433 U.S. at 209.

[60] The Court wrote that "if Delaware were to exercise legitimate *quasi in rem* jurisdiction it would necessarily afford the owner of the property an unconditional opportunity

Thus, the Court could have decided *Shaffer* by simply ruling section 366 unconstitutional because it would force the defendants to submit to *in personam* jurisdiction in contravention to the *International Shoe* due process test.

Perhaps one reason the Court did not base its final holding in *Shaffer* on section 366 was an attempt to avoid a labeling process. The Court had ruled previously that labeling an action *in personam* or *in rem* was an elusive and confused undertaking.[61] But, if this reason were true, the Court was inconsistent in its approach when it ventured in its Jurisdictional Statement to label section 366 as fundamentally *in personam*.

2. Delaware's Situs of Corporate Stock Statute

If the Court had wished to avoid labeling the action *in personam*, it still had one other narrow avenue which it might have used. Under the traditional concept of *quasi in rem* actions, Delaware gained jurisdiction by sequestering stock property which was located within its borders. However, the stock property, an intangible asset,[62] had its situs in Delaware only by virtue of title 8, section 169 of the Delaware Code.[63] Section 169 provided that Delaware was the situs of all stock in corporations formed in Delaware. This provision was contrary to U.C.C. 8-317(1)[64] which provided that the stock certificate was the actual evidence of the stock, and attachment occurred only when the certificate actually was seized. Thus, the defendants were subject to suit in Delaware and also in whatever state the certificates were located.

Because of this inconsistency, section 169 may have denied the defendants due process of law.[65] If section 169 were unconstitutional, Delaware would have had no basis for jurisdiction because the property would not have been within its borders either

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to be heard and would limit any judgment in the proceedings to the property involved." Jurisdictional Statement, *supra* note 59, at 16.

[61] In Mullane v. Central Hanover Bank and Trust Co., the Court would not permit due process to depend on classifications of the action as *in personam* or *in rem*. 338 U.S. 306, 312 (1950).

[62] Folk & Moyer, *supra* note 16, at 788.

[63] DEL. CODE tit. 8, § 169 (1974). The stock certificates were physically located outside of Delaware. Shaffer v. Heitner, 433 U.S. 186, 192 (1977).

[64] "No attachment or levy upon a security or any share or other interest . . . shall be valid until the security is actually seized . . . ." *See*, Folk & Moyer, *supra* note 16, at 788 n.221.

[65] Jurisdictional Statement, *supra* note 59, at 16.

physically or by statutory fiction. Again, the Court recognized this potential avenue in its Jurisdictional Statement.[66]

B. *Contrasting Views of the* International Shoe *Elements of Fairness in Actions Involving Property*

1. The Majority Opinion in *Shaffer v. Heitner*

Of major significance in the majority opinion was the conclusion that *quasi in rem* actions could no longer be maintained by a simple attachment of property within the forum state. The Court refused to accept the traditional premise that the action was against the land and not the landowner.[67] Since the property owner was the real party in interest, jurisdiction over him could result only if he were sued on matters which related directly to his contacts, if any, with the forum state.[68] Such a view was realistic and fair under the *International Shoe* test.

The majority did recognize that in some situations the litigation might concern the defendant's property in the forum state. In that case the property would be significant in evidencing a tie between the defendant's contacts with the state and the nature of the litigation. However, the presence of the property would be only *one* factor supporting jurisdiction,[69] making the action unlike traditional *quasi in rem* actions where the presence of the property was the *sole* factor.

Since the presence of the defendant's property was only one factor, the majority suggested other factors relating to property which might have a bearing on the existence of jurisdiction. Among these considerations were the defendant's reasonable expectancy, the state's interest in the marketability of its property, the location of property records and witnesses, and the interest of the state in resolving disputes concerning its citizens.[70] By raising these factors, the Court demonstrated the many variables that might go into a determination of jurisdiction.

However, the Court did note that the presence of the defen-

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[66] *Id.*

[67] "We think the time is ripe to consider whether the standard of fairness and substantial justice set forth in *International Shoe* should be held to govern actions *in rem* as well as in personam." 433 U.S. at 206.

[68] *Id.* at 207.

[69] *Id.* at 208.

[70] *Id.*

dant's property in the forum state would be an overwhelming factor supporting jurisdiction over the defendant where the litigation involved that property.[71] Conversely, the property would have little significance in evidencing ties where that property was unrelated to the underlying claim.[72] The majority test for jurisdiction over the defendant included not only the defendant's contacts with the forum state, but how, if at all, those contacts related to the litigation.[73] Thus, the Court effectively reshaped the *International Shoe* test by emphasizing a three-cornered evaluation; the defendant, the forum, and the underlying claim must all interrelate. Once such a potentially lengthy determination is made, the forum state has full *in personam* jurisdiction over the defendant.[74]

2. The Concurring Opinions

In contrast to the majority approach were the concurring opinions of Justices Stevens and Powell. Justice Stevens hypothesized that fairness did not necessarily result from a showing of ties between the defendant, the forum, and the litigation.[75] In exemplary cases where the defendant drives through the forum state, opens a bank account, or purchases real estate,[76] Justice Stevens believed it was fair to maintain jurisdiction over the defendant because the defendant could be charged with *expecting* that his activities would subject him to potential liability.[77] If a nonresident accepted the benefits of the forum state he would be charged with assuming concomitant obligations.

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[71] *Id.*

[72] *Id.* at 213.

[73] *Id.* at 208-09.

[74] *Id.* at 203-04.

[75] *Id.* at 217 (Steven, J., concurring).

[76] *Id.*

[77] In some respects Justice Stevens' opinion followed a theory of implied consent expressed in dicta in Ownbey v. Morgan, 256 U.S. 94 (1921). There the Court theorized that if the defendant left property in a state and then absented himself from that state, the state then had jurisdiction over such property in answering all claims against the absent defendant. It was said that the defendant gave his consent *ex necessitate* to such potential liability against his property.

The majority in *Shaffer* did make negative reference to *Ownbey* but it is unclear whether the Court was referring to this aspect of the decision or the procedural question on which the case turned. 433 U.S. at 194 n.10. In U.S. Indus. v. Gregg, 540 F.2d 142, 153 (3d Cir. 1976) the court refused to support the consent *ex necessitate* concept as the sole basis for jurisdiction because it was only dicta.

Expectancy was also an important consideration in the majority opinion. But the majority did not limit the jurisdictional test solely to a finding of expectancy. It went on to suggest other factors which might have a bearing on the sufficiency of ties between the defendant, the forum state, and the litigation.[78] For Stevens, however, a finding of expectancy embodied due process fairness to the property owner.[79] Since expectancy can be attributed to anyone who knowingly leaves property in another state, there was very little difference between this approach and traditional *quasi in rem* jurisdiction. In *quasi in rem* actions, if the property was located within the state, the nonresident was subject to suit.[80] Under Stevens' hypothesis, if the property was in the state, the nonresident property owner could be charged with an expectancy and was therefore subject to its jurisdiction. The only exception would be where intangible property was located arbitrarily in the forum state.

The concurrence was also contrary to the majority opinion in that Stevens did not limit the imputed expectancy of the defendant to obligations arising out of the defendant's contacts with the forum state.[81] Since knowingly possessing property in another state *always* creates contacts between the defendant and that state, it is essential under the *International Shoe* test that potential liability be limited to obligations arising out of the ownership of the property. This factor the majority repeatedly stressed. If not limited, the charge of expectancy would foster the same abuses that existed under *quasi in rem* actions of the second category; the property owner could be held liable on matters unrelated to his contacts with the forum state.

It is noteworthy that under both the majority and Stevens' views no property owner could be charged with expecting suit in another state if he did not know that his property was within that state. Thus, Stevens was able to concur in the judgment because the defendants' stock property was present in Delaware only by

[78] *See* text accompanying note 70 *supra*.

[79] "I would also not read it [the majority opinion] as invalidating other long accepted methods of acquiring jurisdiction over persons with adequate notice of both the particular controversy and also that their local activities might subject them to suit." 433 U.S. at 217, 218-19 (Stevens, J., concurring).

[80] *See* text accompanying note 11 *supra*.

[81] Stevens made no mention of any requirement other than a tie between the state and the defendant which created the expectancy. 433 U.S. at 217 (Stevens, J., concurring).

the arbitrary workings of section 169. The defendants could not be charged with knowledge of the quirks of Delaware situs fictions when they purchased stock on the open market.[82]

However, if the facts in *Shaffer* had been changed slightly it is unlikely that Stevens would have concurred. If the defendants had left the stock certificates in Delaware, under Stevens' approach the defendants could have been charged with expecting suit because they knowingly left their property in the state. Thus, the stock could have been applied to satisfy any adverse judgment for breach of their unrelated fiduciary duties. Under the majority view, the location of the stock certificates would not have changed the results. There still would have been no tie between the defendants' stock (their only contact with Delaware) and the controversy. The fact that there was no connection between the defendants' contacts with Delaware and the underlying claim was a controlling fact for the majority.

Justice Powell's concurrence[83] was similar in effect to Justice Stevens' approach. Powell reserved judgment on the necessity of meeting the *International Shoe* test for a nonresident, if that person owned property which was indisputably and permanently located in the forum state.[84] Powell specifically supported the majority shift in focus to a determination of fairness over the property owner.[85] But, Powell, like Stevens, did not view a finding of ties between the defendant, the forum state, and the litigation as the only method for achieving that fairness.[86] Powell asserted

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[82] *Id.* Lack of expectancy also would flaw jurisdiction under the *Harris v. Balk* doctrine. *See* note 31 *supra*.

[83] *Id.* at 217 (Powell, J., concurring).

[84] Powell wrote:

> I would explicitly reserve judgment, however, on whether the ownership of some forms of property whose situs is indisputably and permanently located within a State may, without more, provide the contacts necessary to subject a defendant to jurisdiction within the State to the extent of the value of the property.

Id.

[85] "I agree that the principles of *International Shoe Co. v. Washington* . . . should be extended to govern assertions of *in rem* as well as *in personam* jurisdiction . . . ." 433 U.S. at 217 (Powell, J., concurring).

[86] One commentator has suggested recently that not only are *quasi in rem* actions involving real property fair but, in many instances, such actions are fairer than the *International Shoe* standard. He reasoned that a nonresident property owner had only a casual interest in the forum state arising from his property there. Thus, under the traditional rules of actions against property he was only subject to liability up to the value of

that his test, based on the permanence of the property, was sufficiently fair to the property owner.[87]

3. Which Standard to Use

Because both the majority and concurring views often would achieve the same results,[88] it is essential to examine their methods of determining jurisdiction. The majority directed the jurisdictional determination toward a fluid process involving a potentially large number of considerations. The concurrences were more mechanical, resulting in a simpler approach to the jurisdictional question. Simplicity is particularly beneficial because the determination of jurisdiction is, after all, a threshold issue.[89] It is also true that the reservations expressed in the concurrences concerned fact situations which were not before the Court in *Shaffer*.[90]

However, both concurrences, in their simplicity, failed to consider restrictions on the jurisdictional test which the majority found central. The jurisdictional test, under the majority view, centered on a weighing of significant factors, as they related to ties among the defendant, the forum state, and the litigation. A finding of such ties necessarily resulted in a limitation on jurisdiction to obligations arising out of the defendant's contacts with the forum state.[91] The concurrences failed to make any such limitations. Since the Court held that the *International Shoe* test is the only test for state court jurisdiction, and since the majority

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his property contact. Because he did have some contact with the state, it was fair to hold him accountable. But it was not fair to make him liable personally. *See*, Smit, *The Enduring Utility of In Rem Rules: A Lasting Legacy of Pennoyer v. Neff*, 43 BROOKLYN L. REV. 600, 627-28 (1977).

[87] "In the case of real property, in particular, preservation of the common law concept of *quasi in rem* jurisdiction arguably would avoid the uncertainty of the general *International Shoe* standard without a significant cost to 'traditional notions of fair play and substantial justice.'" 433 U.S. at 217 (Powell, J., concurring).

However, Powell, like Stevens, made no mention of restrictions on liability to obligations arising out of the owner's contacts with the state. *See* text accompanying note 81 *supra*.

[88] 433 U.S. at 207. The majority wrote that "it would be unusual for the state where the property is located not to have jurisdiction."

[89] Adjudication of the merits cannot proceed if the state has no jurisdiction over the parties. *E.g.*, International Shoe Co. v. Washington, 326 U.S. 310, 314 (1945).

[90] Powell specifically reserved judgment on types of property other than that involved in *Shaffer*. 433 U.S. at 127 (Powell, J., concurring). Stevens was unsure as to the potentially broad reach of the holding. 433 U.S. at 217 (Stevens, J., concurring).

[91] *See* text accompanying notes 71-74 *supra*.

stressed that the defendant's contacts must relate to the litigation, not considering these limitations would result in an incomplete jurisdictional test.[92] Furthermore, the Court held previously that it will not consider simplifying the jurisdictional test for the sake of judicial convenience.[93] Consequently, a finding of ties between the defendant, the forum state, and the nature of the litigation is the definitive test for all assertions of state court jurisdiction.

C. *Application of the* International Shoe *Test to the Facts in* Shaffer

Under *International Shoe,* the majority established that the defendants' sequestered stock property did not evidence sufficient contacts between the defendants and Delaware in regard to the fiduciary breach (the underlying claim). The stock was unrelated. However, Justice Brennan, concurring in part and dissenting in part,[94] strongly disagreed with the majority's failure to find, on reexamination, other ties between the defendants and Delaware concerning these fiduciary duties owed to Greyhound. Brennan viewed as a sufficient contact the directors' association with a corporation which existed solely by the grace of Delaware law.[95]

In contrast, the majority found determinative the failure of Delaware to assert, through statutory enactment, its power to regulate corporate fiduciary responsibilities.[96] This argument infers that since Delaware did not take the initiative to assert legislatively the full degree of state jurisdiction compatible with the Constitution,[97] it is unconstitutional for it to assume otherwise

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[92] 433 U.S. at 207, 212.

[93] *Id.* at 207 n.23. *See also,* Jonnet v. Dollar Savings Bank, 530 F.2d 1123, 1130 (3d Cir. 1976) (Gibbons, J., concurring). Judge Gibbons wrote, "[a]lthough it can be argued that the content of constitutional process due a litigant defending title to property will vary from that due a litigant defending himself from liability *in personam,* there is no reason to believe the Supreme Court presently recognizes such a distinction." 530 F.2d at 1133. *But see,* O'Connor v. Lee-Hy Paving Corp., 437 F. Supp. 994, 997 (E.D.N.Y. 1977). Then the Court, in a decision following *Shaffer,* held that the kind of jurisdiction sought (*in rem, quasi in rem,* or *in personam*) was a significant factor in the determination of jurisdiction. This decision wrongly implied that the test of fairness varies in intensity whether the action is brought against property or person. The action always must be fair to the property owner, as delineated in *International Shoe.*

[94] 433 U.S. at 219. (Brennan, J., concurring in part and dissenting in part).

[95] *Id.*

[96] 433 U.S. at 214.

[97] States need not assert jurisdiction to the full extent permissible under the Constitution. 433 U.S. at 219, 226-27 (Brennan, J., concurring in part and dissenting in part).

constitutional jurisdiction beyond the scope of its jurisdictional statutes.

IV. Effects of the Court's Holding

A. *Actions Against Property*

Even though *International Shoe* is now the basis for all assertions of state court jurisdiction, actions may still be brought under the traditional *quasi in rem* terminology. However, an action against property must be examined anew under the *International Shoe* test.[98] Thus, one may bring an action *quasi in rem* against property, provided there is jurisdiction over the property owner.[99]

Despite this possibility, a serious question arises as to the utility, in most instances, of bringing the action against the property. If the state must base jurisdiction on the *International Shoe* test, it ordinarily would have *in personam* jurisdiction over the defendant.[100] There would be no restrictions on the extent of the remedy. If one brought an action *quasi in rem* against the property, the state would still have to have full *in personam* jurisdiction over the owner. But, because the action was *quasi in rem,* this could result in a judgment limited to the attached property because the plaintiff elected a limited remedy.

One noteworthy exception to this analysis would be a divorce proceeding where the court is adjudicating status. In a recent state court decision following *Shaffer,* the court held that a divorce action, where the wife was not subject to *in personam* jurisdiction, was still maintainable *in rem.*[101] Whether the state had jurisdiction depended solely on *International Shoe.* But, the state met the test because it had a vested interest in protecting its citizens (the husband) and adjudicating the marriage status created therein.[102] If the action had been brought *in personam*

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[98] O'Connor v. Lee-Hy Paving Corp., 437 F. Supp. 994, 997 (E.D.N.Y. 1977).

[99] 443 U.S. at 208. In dicta the Court said: "It appears, therefore, that jurisdiction over many types of actions which now are *or might be* brought *in rem* would not be affected by a holding that any assertion of state court jurisdiction must satisfy the *International Shoe* standard." (emphasis added). *See,* O'Connor v. Lee-Hy Paving Corp., 437 F. Supp. 994, 997 (E.D.N.Y. 1977); In re Rinderknecht, 367 N.W.2d 1128 (Ind. App. 1977).

[100] Shaffer v. Heitner, 433 U.S. 186, 203, 213 (1977).

[101] In re Rinderknecht, 367 N.W.2d 1128, 1134 (Ind. App. 1977).

[102] Under the *International Shoe* test there are situations where the vested interest of the state in protecting its citizens is the dominant factor. This is an example of adjudica-

against the wife the state would have lacked jurisdiction because she had no contacts with the state.[103]

B. *Intangible Property as a Factor in the Jurisdictional Test*

The problems with attaching situs to intangible property have not been solved completely by the ruling in *Shaffer*. The attachment of situs to intangible property will continue to be important simply because the defendant's property within the forum may be a significant factor in the jurisdictional test. One example is the role the intangible stock property played in *Shaffer*. The defendants' stock was still located in Delaware due to section 169,[104] and since the stock was unrelated to the underlying claim, it was not a significant factor in the jurisdictional determination.[105] But, there are conceivable situations where section 169 could be a crucial factor in the determination of jurisdiction. One example might be where a dispute arose over control of stock in a Delaware corporation. If Delaware could exert a strong interest in regulating its corporate securities,[106] jurisdiction might lie in that state because all the defendants had contacts with Delaware concerning the nature of the controversy.

C. *Colorado's Long Arm Statute*

One very real consequence of *Shaffer* is its effect on state attachment and long arm statutes. In *Shaffer*, section 366 was unconstitutional because it provided for jurisdiction over prop-

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tion of status. In such situations the state must provide a forum because one would not exist otherwise. 433 U.S. at 208 n.30. *But see,* Traynor, *Is This Conflict Really Necessary*, 37 TEX. L. REV. 657, 661 (1959).

[103] In re Rincderknecht, 367 N.W.2d, 1128, 1135 (Ind. App. 1977).

[104] Nowhere does the majority specifically state that section 169 is unconstitutional. Under similar facts in U.S. Indus. v. Gregg, 540 F.2d 143, 155 (3d Cir. 1976) the court did not find section 169 unconstitutional. In fact, it used section 169 as a potential factor in the *International Shoe* test.

[105] The Court in *Shaffer* wrote:

> The Delaware courts based their assertion of jurisdiction in this case solely on the statutory presence [§ 169] of appellants' property in Delaware. Yet that property is not the subject matter of this litigation, nor is the underlying cause of action related to the property. Appellants' holdings in Greyhound do not, therefore, provide contacts with Delaware sufficient to support the jurisdiction of that State's courts over appellants. If it exists the jurisdiction must have some other foundation.

433 U.S. at 213.

[106] At 219 (Brennan, J., concurring in part and dissenting in part).

[107] At the beginning of the opinion the majority wrote that the controversy "concerns

erty in disregard of any test of fairness to the property owner.[107] Since the lack of fairness in section 366 was a constitutional issue, the holding necessarily affects similar statutes in the remaining forty-nine states.[108]

Colorado's long arm statute provides that the ownership of real property in the state subjects the owner, without further consideration, to the *in personam* jurisdiction of the state.[109] Under *Shaffer* this provision lacks constitutional muster because, like section 366, it makes no provision for a weighing of other factors. As the majority in *Shaffer* noted, there may be significant factors beyond the mere physical presence of the defendants' property which have a direct bearing on the existence of jurisdiction.[110] Even though the Colorado provision often may achieve the same results, its conceptual framework is contrary to the spirit of *Shaffer.*[111] It is traditionally *quasi in rem* because the presence of property and not the defendant's contacts determine jurisdiction.

D. *Jurisdiction to Attach as Security: An Exception*

One recent decision following *Shaffer* has made a significant exception to the applicability of the *International Shoe* test in the attachment of property. Applying dicta in *Shaffer,* a federal district court in *Carolina Power & Light Co. v. Uranet*[112] permitted the attachment of property in California even though that state did not have jurisdiction over the property owners. However, the property was attached only as security for suit in another state. The property was not used as the basis for jurisdiction to adjudi-

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the constitutionality of a Delaware statute [section 366] that allows a court of that State to take property of the defendant that happens to be located in Delaware." 433 U.S. at 189. The Court did not specifically state that section 366 was unconstitutional but this language combined with the broad ruling in *Shaffer* makes this conclusion unavoidable. If it were not unconstitutional, Delaware could continue to sequester property within its borders without regard for the *International Shoe* test.

[108] 433 U.S. at 219 (Brennan, J., concurring in part and dissenting in part).

[109] COLO. REV. STAT. § 13-1-124(c) (1973). "Engaging in any act enumerated in this statute, whether or not a resident of the state of Colorado . . . submits such person . . . to the jurisdiction of the courts of this state concerning any cause of action arising from . . . (c) The ownership, use or possession of any real estate situated in the state . . . ."

It is noteworthy that the statute restricts actions to obligations arising out of the property owner's contact. In this sense the statute is in keeping with the majority in *Shaffer. See* text accompanying notes 71-74 *supra.*

[110] *See* text accompanying note 70 *supra.*

[111] *See* text accompanying notes 71-74 *supra.*

[112] ___ F. Supp. ___, (N.D. Cal. 1977) (46 U.S.L.W. 2194).

cate the merits of a controversy in California and therefore the *International Shoe* test did not apply.

The majority in *Shaffer* wrote: "A state in which the property is located should have jurisdiction to attach the property, by use of proper procedures, as security for a judgment being sought in a forum where the litigation can be maintained consistently with *International Shoe.*"[113] The effect of this proviso was to recognize a distinction between jurisdiction to adjudicate the merits and jurisdiction to attach property as security for a judgment in another state on the merits. The requirements of this jurisdiction to attach property as security were, according to the decision in *Carolina Light,* (1) The presence of the property in the security state should not be fortuitous, (2) the attachment comport with due process procedure, and (3) the Full Faith and Credit Clause could not otherwise achieve the same results.[114]

The potential value of this attachment device is significant because it assures at least some satisfaction of judgment, like traditional *quasi in rem* actions, while still requiring a fair forum to adjudicate the merits. The only negative aspect in the use of such an attachment procedure would be the bifurcation of the suit.

PROSPECTIVE

With the demise of *Pennoyer v. Neff,* all assertions of state court jurisdiction are now based on fairness to the defendant. However, within the concepts of due process fairness remain many of the vestiges of the old power of the state theory. For example, domicile, residence, and presence, which automatically create jurisdiction over the defendant and which are based on the power of the state, are incorporated into the *International Shoe* test. Several commentators have suggested that these automatic determinations are harmful to the spirit of the fairness because fairness should not be so mechanical.[115] It follows from *Shaffer*

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[113] 433 U.S. at 210.

[114] ___ F. Supp. ___, (N.D. Cal. 1977) (46 U.S.L.W. 2194). In *Carolina Light* the suit was in arbitration and the Full Faith and Credit Clause would not apply to any award.

[115] *See generally,* Folk & Moyer, *supra* note 16.

[116] Presence of the defendant has always been sufficient in itself to create jurisdiction. Although presence does promote "an orderly administration of the laws", International Shoe Co. v. Washington, 326 U.S. 310, 319 (1945), there are situations where presence alone is not fair to the defendant. The situation in Grace v. MacArthur, 170 F. Supp. 442

that if jurisdiction is no longer fair when it is based on a sole determination of the presence of property, then perhaps it is unfair to base jurisdiction automatically on the presence of the defendant. Of course, under the *Shaffer* rationale, residence, domicile, and presence should be significant factors in evidencing ties between the defendant, the state, and the litigation; but, they should not be the sole, determinative factors.[116] If fairness involves any sort of weighing process, other factors besides presence, domicile, or residence should be considered, when applicable, in the jurisdictional test.

Even without these suggested changes, the substantive changes arising out of *Shaffer v. Heitner* will do much to disrupt any assurances where jurisdiction rests. The practicing attorney can no longer bank on mechanical determinations of jurisdiction. These changes also will tend to prolong and confuse litigation, particularly as jurisdiction is a threshold issue. However, the shift in orientation to the defendant property owner and his contacts with the forum state is the only fair approach in an assertion of state court jurisdiction.

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(E.D. Ark. 1959) illustrates this possibility. There the defendant was present in Arkansas, for jurisdictional purposes, when he was served notice on a nonstop plane flying over the state. His simple physical presence was so fortuitous that it should not have been enough to subject him to jurisdiction in the state.

The mechanical use of residence or domiciliary is also objectionable as the sole basis for jurisdiction. This is particularly true with corporations. Since a corporation is a resident of that state where it is incorporated, MODEL BUSINESS CORPORATIONS ACT § 11, it is subject to all suits brought against it in that state regardless of such factors as where the cause of action arose, the nature of the suit, or the corporation's business in the incorporating state. In *Shaffer v. Heitner* it may have been unfair to automatically subject Greyhound to suit in Delaware without at least considering some of these other factors. *Developments in the Law—State Court Jurisdiction*, 73 HARV. L. REV. 909, 933 (1960).